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FINANCIAL MODERNIZATION ACT OF 1988

R E P O R T

OF THE

COMMITTEE ON BANKING, HOUSING, AND
URBAN AFFAIRS
UNITED STATES SENATE

TO ACCOMPANY

S. 1886

together with

ADDITIONAL VIEWS



MARCH 22 (legislative day, MARCH 21), 1988.—Ordered to be printed

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FINANCIAL MODERNIZATION ACT OF 1988

MARCH 22 (legislative day, MARCH 21), 1988.—Ordered to be printed

Mr. PROXMIRE, from the Committee on Banking, Housing, and
Urban Affairs, submitted the following

REPORT

together with
ADDITIONAL VIEWS

[To accompany S. 1886]

INTRODUCTION

The Committee on Banking, Housing, and Urban Affairs, to which was referred the bill S. 1886 to modernize and reform the regulation of financial services, to strengthen the enforcement authority of depository institution regulatory agencies, and for other purposes, having considered the same, reports favorably thereon with an amendment and recommends that the bill as amended do pass.

PURPOSE OF THE LEGISLATION

The major purpose of S. 1886 is to strengthen competition within the financial services industry under a sound and consistent regulatory framework. The bill achieves this objective by repealing the provisions of the Glass-Steagall Act that prohibit affiliations between commercial banks and investment banks. A bank holding company would be authorized to operate a securities affiliate under strict regulation by the Federal Reserve Board and the Securities and Exchange Commission. A securities affiliate would be allowed to engage in all aspects of the securities business except the underwriting of corporate equity securities. A Congressional vote on removing this last barrier must occur in 1991 under expedited procedures.

The Glass-Steagall Act separating the commercial banking and securities industries was enacted in 1933. While many believe the Act has served a useful purpose over the years, rapid changes in our financial system have rendered the Act all but untenable as an expression of national financial policy. The Committee has concluded the time has come to enact a phased repeal of the affiliation prohibitions of the Act while establishing a comprehensive regulatory framework to shape the future development of the two industries. In so doing, it is the intent of the Committee to reassert Congressional influence over the pace and direction of change in our financial system. A failure by the Congress to act will not halt the process of financial change—it will simply transfer the initiative to the regulatory agencies, the courts and the lawyers.

The Committee is not unmindful of the potential risk involved in the decision to embark upon a phased repeal of the affiliation prohibitions of the Glass-Steagall Act. But all reasonable policy options available to the Congress entail some risk. In many ways, the riskiest option is to do nothing while letting our financial system continue its haphazard and unregulated evolution. The Committee believes the bill it has reported is the best course of action. It updates our financial laws to reflect the realities of today's marketplace while fashioning a set of proper safeguards to protect the safety and soundness of our financial system.

The key to the Committee's approach to Glass-Steagall is the requirement that the securities business of a bank generally be conducted in a separate affiliate that would be fully regulated by the Securities and Exchange Commission. For the most part, these activities would be carried out in a separate subsidiary of a parent holding company regulated by the Federal Reserve Board. A bank would be prohibited from lending to its securities affiliate and the securities affiliate would be prohibited from selling securities to the bank. The SEC would be given enforcement authority, not only over the new securities activities authorized in the legislation, but over many of the existing securities activities that are already being conducted by commercial banks under current law. At the same time, the bank regulatory agencies are provided with en-

hanced authority to prevent unsafe or unsound practices within the banking industry. Thus the legislation reported by the Committee represents a substantial strengthening of our current regulatory framework.

Allowing bank holding companies to establish securities affiliates under proper safeguards will increase the level of competition within the investment banking industry. This enhanced level of competition will result in lower financing costs and greater access to capital by business firms, consumers and State and local governments. For that reason, the legislation is strongly supported by business and consumer organizations and State and local governments. The bill also has the full support of the Department of the Treasury, the SEC, the Comptroller of the Currency, the FDIC, and the Federal Reserve Board.

HISTORY OF THE LEGISLATION

The reporting of the Financial Modernization Act is the culmination of a detailed and comprehensive review of our financial structure by the Committee over the last 7 years. After lengthy hearings in the 97th and 98th Congress, the Committee reported legislation in 1984 to modernize our financial laws in the light of current technology. Among other things, that bill (S. 2851) authorized bank holding companies to engage in limited securities activities including the underwriting of municipal revenue bonds, mortgage backed securities and commercial paper. It passed the Senate by a vote of 89 to 5 on September 13, 1984. No action was taken by the House of Representatives.

In August of 1986, the Committee reported legislation (S. 2752) to provide for a \$15 billion recapitalization of the Federal Savings and Loan Insurance Corporation. Financial structure provisions such as those in the 1984 bill were not included because of a disagreement over whether a broader bill could get through the Senate and House in the time remaining. Ultimately, the Senate passed a short-term FSLIC recapitalization bill on the last day of the 99th Congress that was not acted upon by the House.

Early in 1987, the Committee considered a comprehensive proposal to recapitalize the Federal Savings and Loan Insurance Corporation, close certain loopholes in banking law including the non-bank bank loophole, and authorize limited securities powers for bank holding companies. While there was a general consensus that rapid action on the FSLIC issue was called for, there was less of a consensus on how many additional issues should be included with the FSLIC legislation. In particular, there was not a consensus on the extent to which providers of financial services should be allowed to compete with one another.

On March 14, 1987 the Committee reported the Competitive Equality Banking Act (CEBA) which passed the Senate on March 27 by a vote of 79 to 11. This legislation ultimately was signed into

law by President Reagan on August 10. It authorized \$10.8 billion in new borrowing authority for FSLIC, closed the non-bank bank loophole and established a moratorium the Federal bank regulatory agencies' authorizing certain new powers for banks or bank holding companies. The moratorium was in effect until March 1, 1988.

The major purpose of the moratorium was to allow the Committee additional time to build a consensus on a financial restructuring bill. It represented a decision by the Congress to assert its own authority over the process of financial change. Major decisions affecting our financial system belong in the Congress rather than the courts or the Federal regulatory agencies. The deadline established by the moratorium also served as a deadline for the Committee to complete its review and recommend legislation to the Senate.

Following the passage of CEBA by the Senate, the Committee held 14 additional days of hearings on financial restructuring and took over 2,000 bound pages of testimony. These hearings, when added to similar lengthy hearings held over the last seven years, have provided the basis for the Committee's decision to repeal sections 20 and 32 of the Glass-Steagall Act and allow a greater degree of competition between investment banking and commercial banking firms.

On May 21, the Committee heard from representatives of various agencies including Manuel Johnson, Vice Chairman of the Federal Reserve Board; L. William Seidman, Chairman of the Federal Deposit Insurance Corporation; Robert L. Clarke, Comptroller of the Currency; Edwin J. Gray, then Chairman of the Federal Home Loan Bank Board; and Elizabeth F. Burkhart, a member of the National Credit Union Administration Board.

On June 18, the Committee heard from Gerald Corrigan, President of the Federal Reserve Bank of New York; Walter Wriston, former Chairman of Citicorp; and John Weinberg, Senior Partner of Goldman Sachs & Company.

On July 29, the Committee considered bank insurance products, hearing from Robert Hunter, President of the National Insurance Consumer Association; Mark Cooper, Research Director of the Consumer Federation of America; Robert D. Haase, Commissioner of Insurance for the State of Wisconsin; Richard E. Galecki, Commissioner of Banking for the State of Wisconsin; James P. Corcoran, Superintendent of Insurance for the State of New York; and Jill Considine, Superintendent of Banking for the State of New York.

On July 30, the Committee considered the history of the Glass-Steagall Act. Historians testifying included Edwin J. Perkins, Professor of History at the University of Southern California; Donald A. Ritchie, Associate Historian of the U.S. Senate Historical Office; and Edward J. Kelly, III, who appeared on behalf of Morgan Guaranty Trust Company. Henry Kaufmann, Managing Director of Salomon Brothers; Martin Mayer; and Thomas Johnson, President of Chemical Bank, also testified.

On August 5, the Honorable Thomas R. Carper, Member, U.S. House of Representatives, appeared before the Committee. Also appearing was John P. LaWare, Chairman and Chief Executive Officer of Shawmut Corporation. Both promoted specific legislative initiatives.

On August 6, the Committee addressed new securities powers for banks, hearing from George Kaufman, Professor of Finance at Loyola University of Chicago; Alan Fox, Legislative Representative, Consumer Federation of America; Stan H. Sabin, Chairman of the Real Estate Committee, National Association of Realtors; Kent Colton, Executive Vice-President and Chief Executive Officer, National Association of Home Builders; Richard Geltman, General Counsel, National Governors Association; and Richard Guthman, representing the National League of Cities.

On October 13, the Committee focused on the globalization of capital markets, with testimony from John Heimann, Vice Chairman, Merrill Lynch Capital Markets Group; Richard Levich, Professor of Finance, New York University; and Roberto G. Mendoza, Jr., Executive Vice President of Morgan Guaranty Trust Company.

On October 14, the Committee considered the role of new technology in banking. Witnesses included Lowell L. Bryan, Director, McKinsey & Company, Inc.; John Fisher, Senior Vice President, Banc One Corporation; Almarin Philips, Professor of Economics and Law, University of Pennsylvania; David Taylor, Group Executive, Bank Administration Institute; and David Walker, Professor of Finance, Georgetown University.

Following this, the Committee held 6 days of hearings on legislative proposals written by Committee members to repeal Glass-Steagall. These proposals were S.1886, The Financial Modernization Act of 1987; S.1891, The Financial Service Oversight Act; and S. 1905, The Depository Institution Affiliation Act. Commenting on the bill December 1 were Alan Greenspan, Chairman of the Board of Governors of the Federal Reserve System; on December 2, George D. Gould, Under Secretary for Finance, Department of the Treasury; Robert E. Litan, Senior Fellow, The Brookings Institution; Dr. William S. Haraf, J.E. Lundy Scholar and Director, Financial Markets Project, American Enterprise Institute; on December 3, David S. Ruder, Chairman, Securities and Exchange Commission; Robert L. Clarke, Comptroller of the Currency; L. William Seidman, Chairman, Federal Deposit Insurance Corporation; on December 8, E.E. Crutchfield, Jr., Chairman and CEO, First Union Corporation; Robert Stevens, President, Bryn Mawr Trust Company; Edward O'Brien, President, Securities Industry Association; John Bachmann, Chairman of the Board, Securities Industry Association; David Silver, President, Investment Company Institute; on December 9, A. William Bailey, Jr., Vice President, Independent Insurance Agents of America; William J. Bogaard, Executive Vice President and General Counsel, First Interstate Bancorp; Kent W. Colton, Executive Vice President and CEO, National Association of Home Builders; William James Fitzpatrick, Executive Vice President, General Counsel and Secretary, CalFed Inc.; Norman D. Flynn, First Vice President, National Association of Realtors; Harry L. Freeman, Executive Vice President, American Express Company; Robert R. Googins, Executive Vice President, Hartford Mutual Life Insurance Co (representing the American Council of Life Insurance); Robert A. McCrady, Executive Director, State and National Affairs, Independent Bankers of Minnesota; E. James Morton, Chairman and CEO, John Hancock Mutual Life Insurance Company (representing the Financial Services Council); and

Thomas N. Olson, President, Independent Bankers Association. On December 10, New York Fed president Corrigan and Merrill Lynch executive Heimann reappeared before the Committee to conclude the debate.

The Committee met on March 1 and 2 and ordered the bill reported to the Senate by a vote of 18 to 2. Voting to report the bill were Senators Proxmire, Cranston, Riegle, Sarbanes, Dodd, Dixon, Sasser, Sanford, Shelby, Graham, Wirth, Garn, Heinz, Armstrong, Hecht, Bond, Chafee and Karnes. Senators Gramm and D'Amato voted against reporting the bill.

SUMMARY OF THE BILL

Title I: Securities Affiliations of Banks

This title repeals the two provisions of the Glass-Steagall Act that prohibit affiliations between banks and securities firms.

Upon enactment, bank holding companies will be permitted to offer most securities underwriting services through a separately organized affiliate. Within 6 months, the securities affiliate will be permitted to underwrite mutual funds and corporate bonds. Bank securities affiliates may also underwrite corporate equity securities if approved by Congress in an expedited procedure vote that must occur in 1991. Should Congress approve elimination of this last barrier, securities firms engaged in corporate equity underwriting could then purchase and operate a commercial bank through the holding company format.

The bill prohibits a bank from extending any credit to its securities affiliate or making loans to enhance the marketability of securities underwritten by its affiliate.

To protect against undue concentration, the bill bars Federal Reserve approval of new affiliations between any bank holding company with more than \$30 billion in assets and any securities firm with more than \$15 billion in assets. (In the case of U.S. firms, this would bar mergers between any of the 15 largest banking and securities firms.) In addition, other antitrust laws would continue to apply.

Title II: Expedited Procedures

This section sets up an expedited procedure under which qualified banks can establish bank holding companies.

In addition, the procedure for allowing bank holding companies to engage in eligible nonbanking activities is changed from an application procedure to a notice procedure. In acting on such notices, the Board must consider technological or other innovations in the provision of banking or banking-related services.

Smaller banks may join to form a so-called bankers' bank holding company for the purposes of operating a securities affiliate.

Title III: Broker-Dealer Regulation

Together with Title IV, Title III defines the authority of the various bank regulatory agencies and the Securities and Exchange Commission in policing securities activities of banking organizations. Brokers, who make securities transactions for clients, and dealers, who trade for the firm's account, will generally be required

to conduct their activities outside of banks in affiliates or subsidiaries subject to SEC regulation. However, banks can themselves offer brokerage services subject to regulation by the banking agencies if they don't publicly solicit this business or pay brokerage employees volume incentives. Special rules apply for securities transactions in trust departments and other traditional banking areas. In addition, banks can themselves act as dealers if they trade as fiduciaries, or when they trade commercial paper and other specific securities.

Title IV: Investment Companies

Investment companies are overseen by the SEC, and their transactions with affiliated banks are restricted. Also, the SEC will register and oversee investment advisers. Before examining or taking action against a bank, the SEC must notify the bank's primary regulator. An Investment company may not purchase securities during an underwriting if the proceeds help the seller pay off any obligations to an affiliated bank. Nor may they suggest in any way that their products enjoy any kind of Federal bank insurance.

Title V: Enforcement Powers

Title V strengthens and clarifies the enforcement authority of the financial institution regulatory agencies. The authority for these agencies to order affirmative actions including reimbursement, indemnification or restitution is made clear. Individuals removed from one Federally insured institution will be automatically prohibited from participating in the affairs of all others, without prior approval. Civil money penalties will apply for violations of statutes or regulations, as well as cease-and-desist orders. Certain fines are increased from \$100 to \$1,000 per day. In addition, various other enforcement areas in which the agencies' powers are now in doubt have been clarified.

Title VI: Truth-in-Savings

This title reforms savings account advertising. It requires any advertisement or other notice to list prominently the annual percentage yield; any minimum balance; any minimum initial deposit; a Statement of how any fees would reduce the yield; and disclosure of penalties. Interest must be paid based on the average daily balance. Misleading advertising is barred, and agencies may impose fines of up to \$1,000 for each individual harmed by a violation.

The SEC is required to consult with the Federal Reserve to ensure that its regulations for mutual funds follow similar guidelines.

Title VII: Home Equity Loans

Under this title, lenders may neither unilaterally change the terms of a home equity loan nor terminate the loan. In explaining the terms, lenders must disclose the monthly payments along with tax implications, and emphasize that the house serves as collateral. For variable rate plans, the index and formula must be disclosed along with an example of how index changes in the past have altered interest payments. The index must be beyond the lender's control.

Title VIII: Insurance

This title places limits on the ability of bank holding companies to engage in insurance activities across State lines by acquiring State-chartered banks. A bank would not be permitted to provide insurance as authorized by State law in its parent holding company's home State. Current interstate insurance activities that do not conform to this requirement are grandfathered.

National banks may continue to engage in insurance agency activities in towns of 5,000 or less, provided the sales are confined to the town and its environs. Other national bank insurance activities are limited to credit-related insurance.

TITLE I—SECURITIES AFFILIATES OF BANK HOLDING COMPANIES

Title I establishes a framework to permit banking activities and securities activities to be combined in one organization using the holding company structure. A holding company controlling a bank may engage in securities activities through a "securities affiliate" that is separate from the bank and insulated from the bank by a substantial array of safeguards.

This new legislation repeals or amends key sections of the Banking Act of 1933, which are commonly referred to as the Glass-Steagall Act.

New legislation is necessary to respond to the myriad of significant innovations in the financial marketplace in recent years. These changes in technology and market practice could not have been foreseen at the time that Glass-Steagall was enacted. In addition, many believe that Glass-Steagall was not, even in the 1930s, a necessary element of the financial reforms enacted in the aftermath of the Great Depression.

A. Was Glass-Steagall an Appropriate Response to the Financial Crisis of the 1930's?

Economic and legislative historians who have examined the genesis of the Glass-Steagall Act raise substantial doubts whether the separation of commercial and investment banking was a necessary or desirable response to the financial calamities of the Great Depression.

The architects of the legislation appear to have been heavily influenced by the hearings on stock exchange practices conducted by this Committee through its chief counsel, Ferdinand Pecora. The Pecora investigation in the Senate provided detailed testimony on the self-dealing and other market abuses engaged in through securities affiliates by some officers of certain large money center banks.

While eliminating these well-documented abuses was a high priority for legislators, the findings of the Pecora hearings did not establish that the complete separation between commercial banks and investment banks was either a necessary or appropriate response to the problems.

First, abuses by commercial banks that were engaged in securities activities were not a substantial cause of the collapse of the financial system in the early 1930's. Moreover these abuses were not different in kind, or in degree, from the abuses that the Pecora

hearings found securities firms to have been engaged in over the same period.

Second, complete separation of commercial banks from investment banks was not a necessary or efficient means to eliminate those abuses that were unique to firms which combined both commercial and investment banking. Complete separation was a drastic means to regulate the potential conflicts of interest that may arise from the combination of commercial and investment banking. Furthermore, the decision to compartmentalize the different techniques of financial intermediation did create barriers to entry within each market which have since served to inhibit new competitors from providing financial services efficiently and at a minimum cost to the consumer. Both bank entry into securities activity and entry into banking by securities firms would have lowered the costs to users of financial services.

Third, Congress enacted legislation to address the specific abuses and conflicts of interest involved in the combination of banking and securities activities. This legislation included the Securities Act of 1933, and the Securities and Exchange Act of 1934, and section 23A of the Federal Reserve Act. The Securities Act created affirmative duties to disclose information about a securities offering and prohibited the issuance of misleading prospectuses on a securities issue. The Securities and Exchange Act outlawed stock manipulation. Section 23A restricted transactions between a member bank and its affiliates.

These additions to our financial laws remedied many of the deficient market practices exposed by the Pecora hearings in a more specific manner than did the forcible separation of commercial banking from investment banking, and did so without incurring the anticompetitive costs of a financial structure that is divided into compartments.

Fourth, some proponents of Glass-Steagall have argued that restricting the activities of a banking organization is necessary to maintain depositor confidence in the banking system. Proponents assert that restricting the activities of the bank and the asset composition of the bank's portfolio would reduce the likelihood of bank runs.

This argument is moot since the establishment of the Federal Deposit Insurance Corporation in 1933, as part of the Banking Act of 1933. The FDIC guarantees depositors' funds regardless of the composition of the bank's asset portfolio, and thus prevents runs on banks. It appears to have been the profoundly creative device, and not the Glass-Steagall restrictions on affiliations, that significantly stabilized our banking system.

Senator Carter Glass, the primary sponsor of the major banking laws of the day, confirmed his own misgivings about the need for the Glass-Steagall separation just 2 years after the legislation was enacted. In testimony before the committee on July 30, 1937, historian Edwin J. Perkins presented evidence that Senator Glass supported efforts to soften the barriers between investment banks and commercial banks only 2 years after the enactment of Glass-Steagall during Congressional consideration of the Banking Act of 1935. He withdrew his efforts to revise this legislation in August of 1935 only in deference to the wishes of President Roosevelt.

In retrospect, the more fundamental reforms growing out of the financial crisis of the 1930's, such as the Federal Deposit Insurance Corporation, the Securities and Exchange Commission, and strengthening of the Federal Reserve Act each appear to have greatly enhanced the integrity and functioning of our financial system. Each was addressed to a particular problem and has stood the test of time and practice. The Glass-Steagall separation does not appear to have been an essential component of that series of structural reforms designed to restore stability to our credit allocation process. In particular, the Glass-Steagall affiliation restrictions differ from those other reforms in that these restrictions did not appear to address any of the primary causes of the Great Depression. Furthermore, they were a very costly means of regulating conflicts of interest, and the need for such drastic means was questionable, particularly after the enactment of the other financial legislation in 1933 and 1934.

B. The Current Need for Legislation to Modernize our Financial Structure

Whatever the justification for the original Glass-Steagall legislation, the market for financial services has undergone substantial changes over the last 55 years. These changes call into question both the efficacy of the barrier separating commercial and investment banks and the merits of maintaining what is left of that barrier.

Technological change, related innovations in market practice, exploitations of loopholes in the original language, and interpretations of that language by the regulators and the courts blur the distinction between the commercial and investment banking industries.

1. Technological Changes.—Recent developments in computer and telecommunications technology have significantly altered the techniques of financial intermediation. The ability to transmit information quickly and accurately, and to store and analyze that information, have decreased the relative importance of banks as intermediaries and lowered the costs to investors of making a direct evaluation of credit risks. As a result, an ever greater proportion of the transfer of capital from investor to borrower now takes place through direct issuance of securities by borrowers to investors.

One significant example of this new practice is the development of a commercial paper market as an alternative to banks loans as a source of short-term funding. Commercial paper is a short-term negotiable unsecured promissory note issued for a specific amount and maturing on a specific date of not more than 270 days. Most commercial paper issues have a maturity of 30 days or less.

The gains in efficiency and diversification that are afforded by this so-called securitization of credit provide great benefits to both borrowers and lenders. Yet Glass-Steagall, conceived of before the advent of securitization, prohibits commercial banks from entering this market. As a result, large corporations that previously obtained credit from commercial bank lenders have now gone to securities firms to issue commercial paper. In 1965 commercial loans by large banks constituted 85.8 percent of all short term borrowing by nonfinancial corporations. By 1986, commercial loans had fallen to

54.0 percent of the total. Over the same period, commercial paper rose from 1.3 percent to 11.8 percent of the same total.

In effect, this traditional customer of banks has jumped over the Glass-Steagall barrier to obtain benefits that commercial bankers are unable to provide because of legal restrictions. This is despite the fact that banks have the expertise to provide this new service competitively. Glass-Steagall restrictions prohibit entry by a class of providers who would broaden competition and lower the costs to the borrower in the market for commercial paper.

Technical and financial innovation have affected the market for underwriting services as well, making the practice less risky. New instruments and portfolio management strategies that were unavailable just a few years ago have reduced the risk exposure of underwriting.

Traditionally, the risk to the members of the underwriting syndicate on most issues has been significantly diminished by the practice of simultaneously setting the price and distributing the issue to a prearranged group of investors after the close of a day's trading but before the opening on the following day.

More recently, the development of derivative instruments such as futures and options permits the underwriter to further diminish his exposure to risk by providing an opportunity to hedge against the risks of changes in the price of instruments being underwritten. As a result, the underwriter can offset the risk associated with any unsold inventory of the new issue that is underwritten on a firm commitment basis.

A careful examination of the practice of securities underwriting reveals that it is a less risky activity than is commonly believed. Recent innovations in risk management techniques diminish underwriting risk even further and strengthen the case for repeal of the restrictions on bank entry into the market for underwriting services.

2. Glass-Steagall Restrictions Impair the International Competitiveness of U.S. Financial Intermediaries.—The global integration and operation across regulatory boundaries is itself related to the technological and market innovations in recent years. Diversified firms from many countries now offer a wide array of financial services around the globe.

Some characterize the issue of Glass-Steagall repeal as a zero-sum game between banking firms and securities firms. That characterization is inaccurate precisely because of the increasingly integrated nature of world financial markets.

Glass-Steagall restrictions inhibit a U.S. based firm from offering the entire range of financial services to both domestic and foreign customers in the United States. As markets become increasingly integrated, U.S. banks, which have the expertise in securities activities as is evident from their offshore underwriting activity, will be inhibited from exploiting the economies of scale obtainable through the development of worldwide securities operations.

In most countries, there is no forced separation between banking and securities activity. Even in Japan, where the commercial and banking industries are legally separated, the restrictions and separation are much less severe than those created by Glass-Steagall. Japanese law does not inhibit financial regulators from responding

flexibly to innovations in financial market practice. Japanese regulators are permitted to evolve and adapt to changes in the techniques of credit allocation. As a result, U.S. firms are constrained to a much greater extent in the United States than are foreign firms in their home markets with the attendant effects on U.S. firms' relative strength.

In addition, as a result of grandfather rights under the International Banking Act of 1978, more than a dozen foreign firms that are permitted to engage in both banking and securities activity in the U.S. market. In essence, these foreign firms are permitted to enjoy an advantage over U.S. firms in our home-market.

Overall, Glass-Steagall inhibits our firms from developing a basic source of competitive strength in the world market. Repeal would contribute to the vitality of our financial sector in the competition to provide a full range of financial services worldwide.

3. The Glass-Steagall Barrier Has Been Perforated in Both Directions.—Those who would defend the separation of commercial and investment banking must confront the reality that this principle has been violated. American banks underwrite securities all over the world, except in America. For years banks have underwritten securities issued in the Euromarkets through their offshore affiliates. In 1985, for example, 11 American banks underwrote about \$16 billion of Eurobonds, which is substantial in comparison with the \$105 billion of corporate bonds underwritten in the United States.

That some U.S. banks already undertake sizable underwriting activities is not merely evidence of the breakdown of Glass-Steagall. It also illustrates that the large money-center banks currently have the ability and expertise to perform these services.

Antiquated laws have chased American banks offshore where issuance is, if anything, riskier and the possibilities of conflicts of interest are greater because of the lack of public disclosure requirements and other market regulation. Permitting banks to establish securities affiliates in the United States would bring some of this business back home and contribute to the safety and soundness of our financial system.

Another class of banks that can engage in securities underwriting under current law are State-chartered banks that are not members of the Federal Reserve System. A number of securities firms have affiliated with these FDIC-insured banks. In his testimony before the Banking Committee in December of 1987, Mr. John Heilmann of Merrill Lynch said with admirable candor, "We already have a bank."

In fact, most of the top U.S. securities firms are affiliated with banks. Shearson Lehman Hutton is affiliated with four banks including Boston Safe Deposit and Trust Company; Goldman Sachs with Broad Street Bank and Trust. Drexel Burnham Lambert, with both Commercial Trust Company and Harbor Trust Company; Prudential Bache, with Prudential Bank and Trust; First Boston, with Universal Trust Company; Merrill Lynch, with Merrill Lynch Bank and Trust.

The proliferation of such innovations as cash management accounts by many of the investment firms is still another example of

the inroads that the securities industry has made into the traditional banking function of deposit taking.

These combinations are currently exposed to all of the potential conflicts of interest that opponents of Glass-Steagall repeal cite as reasons to maintain the existing legislation. It is illuminating that to date the existing laws, which in this case do not include Glass-Steagall, appear to have been sufficient to deter widespread abuses of conflicts of interest.

Still another penetration of the Glass-Steagall separation exists as a result of the combination of thrift institutions and securities firms. Sears Savings Bank in California is one of our largest thrifts and it is affiliated with Dean Witter Reynolds. Both are owned by Sears.

Banking firms have also increasingly crossed the Glass-Steagall barrier in the other direction, entering into securities activities. For example, banks and bank holding companies may now offer discount brokerage services.

Banks and bank holding companies may also provide brokerage services together with investment advice to large institutional clients.

Banks may also engage in the private placement of commercial paper without violating Glass-Steagall.

Recently, several bank holding companies have received Federal Reserve Board approval to underwrite and deal in municipal revenue bonds, mortgage-backed securities, consumer-receivable-related securities, as well as commercial paper. These also were once considered the strict province of the securities industry.

Still another example of U.S. banks' engaging in securities activities is their role as underwriters and dealers in Treasury securities and general obligation municipal bonds. While neither of these functions violates Glass-Steagall, both illustrate the absence of complete separation between banking and securities activities. The successful presence of banks in these two areas also suggests that they do currently have the expertise to engage in a broader range of securities activity.

The integrity of the functional compartments into which Glass-Steagall placed our financial intermediaries has largely disintegrated. The insulation is gone. All that remains is an array of barriers to entry with little rational basis that merely serve to distort the activities of financial intermediaries and inhibit vigorous competition.

4. The Structure of the Market for Underwriting Services and the Benefits of Glass-Steagall Repeal.—Repeal of Glass-Steagall would eliminate barriers to entry and reduce the price of underwriting services as new suppliers enter the market.

To estimate the magnitude of the impact of new entry on the price of services paid by consumers in a market one can examine the structure of that industry prior to the new entry. Consumer benefits are more likely to result from new entry into a market that is quite concentrated, that is one which has a small number of suppliers.

A market characterized by a small number of suppliers is likely to exhibit some degree of market power that leads to monopolistic inefficiencies. In such a market, substantial new entry can reduce

market power and reduce the likelihood that successful collusion between suppliers could be maintained.

Data on the structure of the investment banking industry obtained from the *Investment Dealers' Digest* suggest that there is a substantial degree of concentration in the market for underwriting services. In 1987 the top 5 firms accounted for 68.7 percent of the underwriting of non-convertible debt issues, 95.7 percent of the underwriting of asset-backed debt, 46.4 percent of common stock issues, 49.3 percent of initial public offerings, and 64.9 percent preferred stock.

In municipal finance, the five largest firms accounted for 42.3 percent of all revenue bond issues in 1987. That can be compared to the market for general obligation municipal issues, where the top 5 firms accounted for 31.7 percent. In the latter market banks are eligible to compete even under the restrictions of Glass-Steagall.

Data on the extent of concentration in the U.S. dealer market for commercial paper reveal that as of March 25, 1987 the top 5 firms account for 95 percent of total outstandings.

Based on this data there appears to be substantial reason to believe that new bank entry would diminish market power and reduce the cost to the customer purchasing underwriting services.

Additional data from *Investment Dealers' Digest* on average fees as a percentage of the value of an issue reveal that in 1987 the average fee on publicly-traded common stock was 5.62 percent and for initial public offerings was 7.86 percent.

The cost of capital to the issuer during an initial public offering is also raised by another factor—underpricing. Underpricing is very expensive to the issuer. It helps the underwriter in two ways. First, it makes it easier to place an issue and minimizes the risk that the underwriter will have to tie up capital and carry a portion of the issue in its inventory. Second, the underwriter can make money for his own trading account by holding the issue and selling only after the price rises. Statistics cited by Thomas Pugel and Lawrence J. White in their study of the economics of securities underwriting show that, on average, the initial public offering of new stock is underpriced by over 18 percent as measured by the price in the offer market.

The evidence on the opinion of the consumers of financial services supports those who believe that new competition resulting from Glass-Steagall repeal would produce benefits. There is a broad body of evidence that is in agreement.

The Committee's survey of the chief financial officers of the Fortune 500 corporations shows that 77 percent favor repeal of Glass-Steagall. The National Association of Manufacturers has also endorsed Glass-Steagall repeal. These two groups constitute the major consumers of corporate debt and equity underwriting as well as commercial paper underwriting.

The National Association of Home Builders has suggested in hearings before this Committee that a consumer will save nearly \$1,000 over the life of a \$100,000 mortgage because of increased competition in the market for underwriting mortgage-backed securities.

State and local governments believe that they would benefit as well. The National Governors Association, the National Conference of State Legislators, National League of Cities, National Association of Counties, U.S. Conference of Mayors, and the Government Finance Officers Association all support provisions to permit banks to underwrite and deal in municipal revenue bonds. It is estimated that permitting banks to underwrite municipal revenue bonds could have saved State and local governments as much as \$480 million in 1986.

5. Summary.—The argument for legislation to modernize our financial structure is strong. A substantive case can be made that at its inception the Glass-Steagall legislation was: (1) an unnecessary response to the forces that caused the financial calamities of the 1930's; (2) an inefficient and very costly means to control abuses identified by the Pecora hearings; and (3) superseded by many of the subsequent legislative reforms of the 1930's.

Furthermore, changes in the technology and practice of financial intermediation have rendered the restrictions of Glass-Steagall ineffective and obsolete. Regulatory innovations and court decisions have responded to the tensions raised by the clash between changed market practices and the 55-year old law. The barrier separating commercial banks from investment banks has been perforated in both directions. The restrictions of Glass-Steagall that remain constrain U.S.-based firms in their effort to compete in a global market. Perhaps most importantly, the restrictions of Glass-Steagall that continue to serve as a barrier to entry which protects a highly concentrated market structure in some segments of the underwriting services industry and inhibits the competitive provision of financial services to the consumer at the least possible cost.

C. Committee Action

Significant cost savings can be achieved through the promotion of new competition in the financial services industry. At the same time permitting banking and securities operations to be conducted jointly requires explicit provisions to prohibit the emergence of conflicts of interest and threats to the safety and soundness of the financial system.

The centerpiece of the action taken by the Committee is the creation of a structure within the holding company framework to permit banking and securities affiliates to coexist. The holding company structure, together with further explicit inter-affiliate restrictions, provide the required insulation between the bank and the securities affiliate to: (1) promote impartial credit decisions; (2) promote financial system stability; and (3) deny bank securities affiliates an unfair funding advantage because of their association with an insured deposit-taking entity.

1. The Holding Company Structure and the Securities Affiliate.—The bill repeals sections 20 and 32 of the Glass-Steagall Act and establishes a new framework for commercial banks to become affiliated with securities firms and for securities firms to become affiliated with commercial banks. The framework builds on the Bank Holding Company Act of 1956, which regulates companies that control commercial banks and the nonbank subsidiaries of those companies. At the heart of the new framework is the "securities affili-

ate"—a nonbank subsidiary of the bank holding company carefully insulated from the bank.

Conducting the bank-securities activities through holding company affiliates of a bank is a much sounder alternative than allowing subsidiaries of the bank to engage in a full range of new securities activities.

There are a number of reasons for this. The temptation for the bank to support an ailing subsidiary would be very strong given that the consolidated balance sheet of the bank would directly reflect the securities activity. In addition, keeping the decisions of the securities subsidiary distinct from the aims of the officers and directors of the bank would be infinitely more difficult than ensuring that separately capitalized banking and securities affiliates of the holding company acted independently. The Administration took the same view of the problem in 1983 and 1984, when the Banking Committee was considering legislation to grant new bank powers.

The Secretary of the Treasury testified that "the Administration believes strongly that the holding company structure is the only acceptable means of expanding nonbanking activities." The Secretary then stated emphatically that the Administration did not believe

that nondepository institution activities should be conducted through a subsidiary . . . in which a bank or thrift has a direct equity investment. Such bank or thrift investments would be at risk if the subsidiary's activities were to falter, and the subsidiary's cost of capital would be lower as a result of Federal assistance not available to competitors. Neither problem arises if the holding company approach is adopted.

A further consideration, which reinforces the choice of the holding company structure, is the recognition that permitting several different forms of bank-securities unit structure could lead to a competition in regulatory laxity, as each regulatory agency sought to make its structural alternative more attractive to potential clientele. Such an interaction could, over time, significantly erode the prohibitions on exploiting self-dealing possibilities and the safety of the banking system.

Several academic observers have upheld this view. Robert E. Litan, in his recent book *What Should Banks Do?*, summarizes the case:

Requiring all nonbank activities to be operated within a holding company structure would end the growing disparity between the range of nonbank activities open to bank holding companies, which the Fed regulates, and those open to State-chartered banks in certain States where banks may directly engage in nonbank activities not approved for bank holding companies. More important, the holding company approach, however imperfect, is more likely to prevent deposit insurance from subsidizing nonbanking activities, as would occur if banks were allowed to invest directly in nonbank enterprises. In the holding company mechanism, the nonbank activities do not appear on the asset side of the bank's balance sheet; under the alter-

native structure, they clearly would. Finally, requiring that financial activity diversification proceed only through the holding company mechanism would vest agencies at the Federal level with all responsibility for supervising the transactions and affiliations between the nonbank and bank activities. This requirement would minimize jurisdictional overlaps between State and Federal agencies, as well as unnecessary duplication in overseeing nonbank activities in which depository organizations may be engaged.

2. Inter-affiliate Restrictions—("Firewalls").—The bill imposes a series of restrictions on securities affiliates and affiliated banks for several reasons. First, it is imperative to promote impartial credit decisions by the bank. One would not want bank credit decisions to be affected by concern for the reputation of the securities affiliate or concern for the success or failure of a particular securities affiliate activity. Second, a securities firm affiliated with a bank should not have an unfair funding cost advantage because of the existence of deposit insurance for creditors of the bank. Third, the decision-makers in charge of the securities affiliate should be clearly aware that in the event of a loss the securities affiliate will not come under the umbrella of insurance protection. This is an important consideration both because it is important not to extend the deposit insurance fund to cover activities it was not intended to cover, and because the securities affiliate would have an incentive to engage in excessive risk taking out of the belief that any losses would be insured.

The list of the explicit "firewall" provisions contained in the bill include the following:

- (1) A bank affiliated with a securities affiliate may *not*:
 - (a) extend credit in any manner to the securities affiliate (except for an extension of credit that is made in the course of clearing U.S. Government or agency securities, is fully secured by those securities, and is to be repaid on the same calendar day);
 - (b) purchase for its own account any financial asset of the securities affiliate;
 - (c) issue a guarantee, acceptance, or letter of credit for the benefit of the securities affiliate; or
 - (d) extend credit in any manner to any investment company for which the securities affiliate acts as investment adviser, or whose shares are distributed by the securities affiliate.
- (2) The bank may not extend credit—or enter into a standby letter of credit, guarantee, or other facility—for the purpose of enhancing the marketability of securities that are being underwritten or distributed by the securities affiliate.
- (3) Neither the parent bank holding company nor any of its bank or nonbank subsidiaries (other than a securities affiliate) may knowingly extend credit secured by or for the purpose of purchasing any security while, or for 30 days after, the securities affiliate is underwriting the security.
- (4) The bank may not extend credit to an issuer of securities underwritten by the securities affiliate, for the purpose of paying principal, interest, or dividends on those securities.

(5) No officer or director of a securities affiliate may serve at the same time as an officer or director of the bank (a) unless the bank holding company has total banking assets of \$500 million or less, or (b) except pursuant to an exemption granted by the Federal Reserve Board.

(6) The securities affiliate must make certain written disclosures emphasizing that the securities affiliate is separate from any affiliated bank, and that securities handled or recommended by the securities affiliate are not insured deposits.

(7) The bank may not express any opinion on the value of—or the advisability of purchasing or selling—securities that are being underwritten, distributed, or dealt in by the securities affiliate, without informing the customer of the securities affiliate's role.

(8) Nonpublic information about a customer may not be disclosed by the bank to the securities affiliate—or by the securities affiliate to the bank—without the customer's consent.

(9) The securities affiliate may not underwrite or distribute securities that are secured by, or represent an interest in, mortgages or other obligations originated by the bank unless the securities are rated by an unaffiliated, nationally recognized statistical rating organization.

(10) The three Federal banking agencies and the SEC must each establish a program for ensuring that the banks and securities affiliates it supervises comply with section 4(c)(15), and for responding to any complaints from customers about inappropriate cross-marketing of securities products or inadequate disclosure.

Any FSLIC-insured thrift institution controlled by a bank holding company is subject to the same restrictions as a bank.

The holding company framework, in conjunction with the fire-wall provisions and the disclosure requirements, anti-tying statutes, and prohibitions on stock manipulation contained in existing law, provides a structure to promote new low cost competition in the provision of financial services. This new legal framework significantly curtails the abuses associated with banking and securities combinations that diminish confidence in our financial system's efficiency and integrity.

3. Capital Standards for Bank Holding Companies With a Securities Affiliate.—The bill includes a provision that adjusts the capital standards for bank holding companies and their securities affiliates for two important purposes: to promote the safety and soundness of the bank holding company; and to promote functional regulation of the securities affiliate as well as competitive equity between the securities affiliate and securities firms unaffiliated with banks.

The provision promotes safety and soundness in two ways. First, it requires a bank holding company to establish a capital cushion in order to invest in and maintain a securities affiliate. Specifically, a bank holding company may invest in a securities affiliate only with capital over and above the capital necessary to satisfy minimum bank holding company capital requirements. As a result, if the securities affiliate were to fail, the bank holding company's loss of its capital investment in the securities affiliate would not impair its ability to satisfy minimum capital requirements.

Second, the provision curtails a bank holding company's ability to engage in "double leveraging" to avoid its minimum bank holding company capital requirements. That is, a bank holding company would be required to establish a capital cushion if it borrowed money, used the proceeds to purchase stock in its securities affiliate, and then directed the securities affiliate to use the capital to support its own borrowing.

The provision promotes functional regulation and competitive equity by ensuring that the securities affiliate is subject to the same SEC-mandated capital standards as securities firms unaffiliated with banks, but is not itself subject to additional capital standards imposed by the Federal Reserve Board on bank holding companies.

The SEC imposes stringent capital requirements on brokers and dealers pursuant to section 15(c)(3) of the Securities Exchange Act. These requirements are fundamentally different from bank holding company capital standards because they are intended to deal with the risks inherent in securities activities, rather than the risks inherent in banking. Accordingly, it is appropriate that a securities affiliate be governed by SEC capital requirements, rather than bank holding company capital standards.

4. Concentration Limits on Mergers—to Promote Competition.—To insure that repeal of Glass-Steagall results in new lower cost competition rather than in financial sector concentration, the bill includes a very important provision that prohibits mergers between bank holding companies with assets of more than \$30 billion and securities firms with assets of more than \$15 billion. With respect to U.S. firms, this provision would stop mergers between the 15 largest bank holding companies and the 15 largest securities firms. Furthermore it would stop large foreign banks and securities firms from combining with the large U.S. firms as well.

Former FDIC chairman William Isaac identified the importance of limiting concentration in our financial industry with appropriate understatement: "Making sure that there are plenty of alternative means of gaining access to credit is more important than making sure you have, say, plenty of choices of beer."

Few observers contest the need for concentration limits. Notes former SEC commissioner Stephen J. Friedman, "It would not be desirable for Morgan Stanley, Salomon, Goldman Sachs and Merrill Lynch to each be acquired by a major bank. But it is hard to see why it would not be very pro-competitive for major banks to compete with those firms on a de novo basis."

The limits contained in this bill are designed to inhibit development of mega-financial service firms who could translate the benefits of consolidation into monopoly profits rather than into greater competitive efficiency.

Economic studies confirm that unconcentrated financial industries foster competition and growth. Studies by Herbert Baer and Sue Gregorash for the Federal Reserve Bank of Chicago, along with the International Monetary Fund show that countries with unconcentrated financial industries experienced stronger overall growth. The five largest banks in the United States have never accounted for more than 19 percent of total banking assets. In Japan, the five largest have never controlled more than 32 percent. And these two

countries have led the world in economic growth. By contrast, the five largest banks in the United Kingdom constitute 73 percent of total bank assets. In France, the five largest have accounted for as much as 87 percent. Among developed countries, these two have traditionally lagged in overall economic growth.

Economists at Morgan Guaranty Trust Co. have argued that high profits at investment banks derive from monopoly positions. For example, mortgage-backed security underwriting is commanded by a few firms. At two of the leaders, this one activity has accounted for more than 40 percent of profits, according to McKinsey & Co.

Prohibiting undue concentration is the best assurance we can provide that credit will be extended fairly and across a wide spectrum of activities. This is of particular importance to small and regional borrowers who fear that they would be overlooked by financial goliaths. Such a development would hamper the dynamic flexibility that has been the hallmark of this country's success for two hundred years.

5. Securities Powers.—The bill permits a securities affiliate to underwrite, distribute, and deal in most types of securities. Corporate debt, mutual fund, and equity securities may not be underwritten immediately. A phase-in approach is adopted, as described below.

In addition to permitting a securities affiliate to underwrite, distribute and deal in securities the bill authorizes a securities affiliate to conduct (1) other securities activities that are permissible for SEC-registered brokers, dealers, or investment advisers (e.g., brokerage, private placement, and investment advising); and (2) other nonbanking activities that are permissible for bank holding companies (e.g., leasing, mortgage banking, management counseling, financial counseling, and dealing in precious metals).

A securities affiliate must be registered with the SEC as a broker or dealer, and is fully subject to SEC regulation. The principle of functional regulation is thus maintained. A bank holding company must conduct any underwriting, dealing or distribution activities through the securities affiliate. The only exceptions are certain activities that are permissible to national banks (e.g. underwriting U.S. Government or State and local securities).

6. Phase-In Schedule.—Authority to underwrite, distribute, and deal in investment company securities (such as mutual fund shares) and certain corporate debt securities is delayed for 180 days after the bill becomes law. Authority to underwrite, distribute, and deal in equity securities (e.g., common stock) is contingent on a separate congressional vote to be held not later than April of 1991.

The bill provides for a phase-in of those powers to provide time for all involved to make the organizational and behavioral changes that are necessary to permit the nation to reap the benefits of repeal while avoiding any potential disadvantages.

A phase-in approach was initially suggested by the U.S. General Accounting Office (GAO) in its report, *Bank Powers: Issues Related to Repeal of the Glass-Steagall Act*. The GAO recommended "in order for the nation to experience the potential benefits of repeal, that certain commensurate steps be taken . . . assuring adequate capitalization, stipulating a specific organizational structure, and providing necessary regulatory oversight." GAO recognized that achieving these objectives would take time.

7. Application procedure.—A bank holding company's acquisition of a securities affiliate (whether a newly formed company or an existing broker or dealer) is subject to the net-public-benefits test of section 4(c)(8) of the Bank Holding Company Act. That test requires the Board to weigh the anticipated public benefits of the proposed acquisition (such as increased competition, greater convenience, or gains in efficiency) against possible adverse effects (such as undue concentration of resources, decreased or unfair competition, conflicts of interest, or unsound banking practices). Even if the acquisition meets that test, the Board may not—during the first 4 years after the bill becomes law—grant approval unless it is satisfied that the bank holding company has the managerial resources to conduct the proposed activities safely and soundly.

The Committee intends that the Board, in reviewing proposals to acquire securities affiliates, abide by the principle of functional regulation. Specifically, the Board should rely on the SEC's expertise in determining the adequacy of the managerial and financial resources of a proposed securities affiliate.

8. Securities affiliations of FDIC-insured banks.—Under the Glass-Steagall Act, affiliations between banks and securities firms have developed through loopholes—through unlocked side windows and cracks in the floor. The bill requires such affiliations to be formed through the front door of section 4(c)(15). Specifically, the bill prohibits an FDIC-insured bank from being affiliated—except through section 4(c)(15)—with any company that underwrites or deals in securities in the United States (except for certain securities that national banks are authorized to underwrite or deal in). Affiliations that existed on March 5, 1987, are grandfathered. In addition, the general prohibition does not apply to certain limited-purpose banks.

9. Securities activities of national banks.—The bill authorizes national banks to underwrite municipal revenue bonds. In addition, if a national bank is not affiliated with a securities affiliate, the national bank may (1) sponsor unit investment trusts (i.e., investment companies whose securities portfolios are fixed at the outset) that invest only in certain securities that a national bank is authorized to underwrite (e.g., tax-exempt municipal bonds), and (2) distribute securities of investment companies that are not affiliated with the bank.

10. Diversified financial holding companies.—If a company that controls a bank qualifies as a diversified financial holding company, the bill (1) permits that company to continue to engage (up to 20 percent of its consolidated assets) in financial activities in which it engaged as of March 1, 1988, even if those activities are impermissible for bank holding companies, and (2) exempts that company from certain examination and capital requirements applicable to bank holding companies. In other respects (including restrictions on securities activities), a diversified financial holding company is treated like a bank holding company.

To qualify as a diversified financial holding company, a company must (1) engage only in financial activities; (2) devote 80 percent of its consolidated assets to activities permissible for bank holding companies under certain provisions of the Bank Holding Company Act; (3) have no more than 20 percent of its consolidated assets in

FDIC-insured banks or FSLIC-insured thrift institutions; (4) have no more than 40 percent of its consolidated assets in depository institutions of any kind (including foreign depository institutions); and (5) refrain from cross-marketing its banking products with products not permitted for bank holding companies.

11. Summary.—The Glass-Steagall separation between commercial and investment banks is no longer effective or useful regulation. A combination of technological and market innovations have effectively broken down many of the insulation properties it was intended to provide.

Furthermore, the complete compartmentalization of functions in the financial services industry is a cumbersome and costly means to regulate conflicts of interest in the provision of financial services. It is costly because the remaining barriers of Glass-Steagall serve to inhibit new entrants who could provide services at lower cost to the consumer.

Consumers of financial services have strongly endorsed the repeal of Glass-Steagall. All of the regulatory agencies who have the responsibility to ensure the safety and soundness of our financial system support this bill—the Federal Reserve Board, the Securities and Exchange Commission, the Federal Deposit Insurance Corporation, the Comptroller of the Currency and the Department of the Treasury—and agree that the bill will allow the U.S. economy to enjoy the benefits of competition in financial services without compromising safety and soundness.

For example, Chairman Ruder of the Securities and Exchange Commission states:

The Commission believes that modification or repeal of Glass-Steagall, accompanied by implementation of the proposed amendments (which are included in the bill) will result in increased competition in the financial services industry, without diminishing important investor protections.

Chairman Greenspan of the Federal Reserve states:

Specifically, in the Federal Reserve's role as a bank regulator, we believe that the firewalls established by (this bill) are fully adequate to protect insured banks from any of the perceived risks involved in securities activities, including the underwriting of corporate debt and equity. We also are confident that we have the necessary resources to assure that banking organizations engaging in securities activities will be vigorously and effectively supervised.

TITLE II—EXPEDITED PROCEDURES

A. Expedited Procedures for Forming Bank Holding Companies

Section 3(a)(1) of the Bank Holding Company Act currently requires a company to receive the Federal Reserve Board's prior approval before acquiring control of a bank and thereby become a bank holding company. In order to streamline these requirements, section 201 establishes a 30 day notice procedure in place of the present application procedure, for the formation of bank holding

companies. This simplified procedure may be used if three conditions are met. First, the person or persons forming the holding company must maintain substantially the same proportional interest in the holding company as they had in the bank. Second, the new bank holding company must meet the capital and other financial standards prescribed for such a bank holding company by the Board. Third, the new company may not be engaged in any non-banking activities directly or through a nonbank subsidiary.

Section 202 would also exempt the formation of a bank holding company from the securities registration requirements of the Securities Act of 1933. That Act generally requires securities to be registered with the SEC, but provides exemptions from that requirement. Section 202 adds an exemption for offers or sales of equity securities made in connection with the formation of a bank holding company under the simplified procedure established by section 201 of this Title. Sections 201 and 202 are intended to reduce the cost of forming a bank holding company and assist small banks in converting to holding companies so they can take full advantage of the new powers being made available by this Act.

B. Expedited Procedures for Section 4(c)(8) Approvals

Under section 4(c)(8) of the Bank Holding Company Act, the Federal Reserve Board may authorize a bank holding company to engage in activities "so closely related to banking or managing or controlling banks as to be a proper incident thereto." Section 203 of Title II amends the 4(c)(8) standard by specifically providing that the Board should, when making its determination, also take into account technological or other innovations in the provision of banking or banking-related services. The intent of this provision is to ensure that the Federal Reserve Board has authority to consider such factors in administering the closely related test.

Section 203 also provides new, streamlined procedures for bank holding companies seeking to engage in non-banking activities under section 4(c)(8). Under current law, a bank holding company must file an application to engage in non-banking activity and await Federal Reserve review and final action.

Under the new procedures forth in section 203, the bank holding company applicant must give the Board 60 days advance notice of its intent to acquire the shares of a company engaging in a non-banking activity. The applicant may then proceed to complete the acquisition after the 60-day period expires, unless the Board issues an order disapproving the proposal, or extending the time period in order to obtain additional relevant information. Any such extension order may be reviewed in the appropriate court of appeals. (Notices involving insurance activities must be published in the Federal Register and must be resolved by Board order.)

The acquisition may take place before the 60-day period expires if the Board issues a written Statement of its intent not to disapprove the application. No notice would be required by a bank holding company for additional offices or changes of office locations for activities previously authorized for the same holding company. A public hearing is not required under the new procedure.

The notice required under this new 60-day procedure shall contain such information as the Board may prescribe by regulation or

by specific request, except that all information requested must be relevant to the nature and scope of the proposed activity and to the Board's evaluation of the activity.

If a notice involves insurance activities, the Board shall publish in the Federal Register notice of receipt of the notice, and shall also provide a reasonable period of time for public comment on it. The Board shall issue an order regarding its disposition of any notice regarding issuance.

C. Reduction in Waiting Period for Bank Acquisitions and Mergers

Under the Bank Holding Company Act an application by a bank holding company to acquire an additional bank or to merge with another holding company must be approved by the Federal Reserve Board. If the merger is approved it still may not, with certain limited exceptions for emergency acquisitions, be consummated for thirty days while the Department of Justice may seek to block the merger under the antitrust laws. In practice the Department of Justice reviews the proposed merger at the same time the Board does. However, apart from certain emergency acquisitions of failing banks or bank holding companies, the 30-day waiting period applies even if the transaction in question would have no effect on competition and is not opposed by the Department of Justice.

To expedite mergers where no competitive problems exist, section 204 amends section 11(b)(1) of the Bank Holding Company Act so as to permit the Board, with the concurrence of the Attorney General, to shorten the 30-day waiting period. The requirement for the Attorney General's concurrence ensures that the Department of Justice can insist on the full 30-day waiting period if it has any qualms whatever about the competitive aspects of the proposed transaction. The waiting period cannot under this section be less than 5 days.

Similarly an FDIC-insured bank (as opposed to a bank holding company) needs approval under section 18(c) of the Federal Deposit Insurance Act (a provision commonly known as the "Bank Merger Act") to merge or consolidate with, acquire the assets of, or assume liability to pay any deposits of another bank. Under section 18(c)(6) such transactions cannot be completed for 30-days after they are approved so the Department of Justice can enjoin an anticompetitive transaction before it is consummated. In order to speed completion of mergers where no competitive problems exist, section 205 amends section 18(c)(6) so as to permit the appropriate Federal banking agency, with the concurrence of the Attorney General, to shorten the 30-day waiting period. The waiting period cannot, in any event, be less than 5 days.

D. Amendments to the Depository Institution Management Interlocks Act

The Depository Institution Management Interlocks Act of 1978 prohibits a management official of one depository institution or depository institution holding company from serving as a management official of another unaffiliated institution or holding company located nearby, or in the case of larger organizations, anywhere. Section 206 makes five changes to this Act.

Section 206(a) concerns the test for "affiliation". The Interlocks Act currently provides that two depository institutions are affiliated, and thus exempt from the Act's prohibitions, if more than 50 per cent of the voting stock of one institution is beneficially owned in the aggregate by one or more persons who also beneficially own in the aggregate more than 50 per cent of the voting shares of another institution. Section 206(a) changes this test by lowering the common ownership threshold from 50 to 25 per cent.

The Interlocks Act currently treats advisory and honorary directors the same as other directors. (12 USC 3201(4)). Section 206(b) exempts from the Act's prohibitions advisory and honorary directors of depository institutions with assets of less than \$100 million. This action was taken to ease the compliance burden on smaller banks where qualified directors may not be readily available.

Section 206(c) provides a 5 year exemption from the prohibitions of the Interlocks Act for a depository institution or holding company that closes, or is in danger of closing (as determined by the principal Federal regulator of that institution or holding company) and is acquired by another depository institution or holding company. Five years after the acquisition the exemption expires.

Section 206(d) establishes an exemption from the Interlocks Act for diversified savings and loan holding companies pursuant to which a director of an unaffiliated depository institution or holding company may also serve as a director of the diversified savings and loan holding company (but not as a director of the holding company's subsidiary depository institutions).

Under this exemption, the primary Federal supervisors of the depository institutions involved must be given 60 days advance notice of the proposed dual service. Either regulator may object, and thus prevent the dual service, if it finds that the dual service raises certain antitrust, conflict of interest, or safety and soundness concerns. Dual service may also be prohibited if the unaffiliated depository institutions involved are found to be in substantial competition with each other in the primary metropolitan statistical area in which the diversified savings and loan company's subsidiary depository institution is located.

Section 206(e) extends the grandfather provision already in the Interlocks Act. The Act currently grandfathers a management official whose service began before the enactment of the original Interlocks Act in 1978. These grandfather rights are currently set to expire on November 10, 1988. Section 206(e) extends these grandfather rights for an additional 5 years.

E. Bankers' Banks

A bankers' bank is a bank that is owned exclusively by other depository institutions and is engaged exclusively in providing services to other depository institutions, their officers, directors, and employees. A bankers' bank holding company is a company that controls a bankers' bank and is itself owned by depository institutions. Through a bankers' bank, a group of banks (in particular, small banks) can provide services to themselves on a cost efficient basis that they might otherwise have to purchase from correspondent banks.

This section modifies certain provisions of existing Federal law to clarify that bankers' banks may be organized in a holding company framework and may be owned by depository institution holding companies as well as by depository institutions directly. This section also clarifies that a bankers' bank chartered by the Comptroller of the Currency and organized within a bank holding company would not be required under the provisions of the Bank Holding Company Act to obtain FDIC insurance. Finally, this section permits the Federal Reserve Board to raise the lending limit on certain collateralized loans made by banks, including bankers' banks, that are members of the Federal Reserve System.

The restrictions in section 4(c)(15) of the Bank Holding Company Act (added by section 102 of the bill), including the restrictions on transactions with affiliates, apply to each bank that is a shareholder of or participant in any bankers' bank holding company that establishes a securities affiliate under this bill.

TITLE III—BROKERS AND DEALERS

Under Titles I and II of the bill, a bank holding company's securities affiliate is subject to functional regulation by the Securities and Exchange Commission ("SEC") as a registered broker-dealer under the Exchange Act of 1934 (the "Exchange Act"). Title III extends the functional regulation concept to certain securities activities engaged in by banks outside the context of the new securities affiliate.

Specifically, Title III subjects certain bank broker-dealer activities to the same type of SEC regulation as nonbank broker-dealer activities. However, the bank regulators, rather than the SEC, will continue to regulate those securities activities that are closely connected to traditional banking activities.

Where SEC regulation applies, a bank will be required to spin out its broker-dealer activities into a separate corporate entity that is registered as a broker-dealer with the SEC. This separate entity includes either a bank operating subsidiary, or a holding company affiliate established pursuant to either section 4(c)(8) or section 4(c)(15) of the Bank Holding Company Act.

BACKGROUND

The Exchange Act currently excludes banks from its definitions of "broker" and "dealer". As a result, a bank may engage in permissible securities activities directly, subject to regulation by the appropriate bank regulator, but is not subject to SEC registration, reporting, and other requirements applicable to other brokers and dealers. This general exclusion reflects the fact that bank brokerage and dealer activities are subject to extensive regulation by the Federal banking agencies and normally are conducted in conjunction with traditional bank functions, such as trust and fiduciary activities.

In 1985 the SEC issued its Rule 3b-9, which would have subjected a variety of bank securities activities to Exchange Act regulation in addition to bank regulation. However, a U.S. court of appeals held that the rule was beyond the SEC's statutory authority. *Amer-*

ican Bankers Association v Securities and Exchange Commission, 804 F.2d 739 (D.C. Cir. 1986).

As banking organizations expand the scope of their broker-dealer activities, it is appropriate that SEC review apply as a general matter to bank securities activities, while minimizing regulatory overlap and complexity. Title III accomplishes this by adopting principles embodied in the SEC's Rule 3b-9: A bank engaging in securities activities, publicly or for profit, and apart from traditional banking activities will be subject to SEC regulation; but a bank may continue to engage in certain securities activities connected to traditional banking activities subject to primary supervision by its appropriate bank regulator.

The SEC, the Federal Reserve Board, the Comptroller of the Currency, and the Federal Deposit Insurance Corporation have all endorsed Title III.

BROKERAGE ACTIVITIES

Title III amends the definition of "broker" in the Exchange Act to include any bank that publicly solicits securities brokerage business or that receives compensation for executing securities transactions in excess of incremental costs ("incentive compensation"). A bank that falls within the definition of "broker" would have to conduct its brokerage activities in a nonbank subsidiary or affiliate registered with the SEC and subject to SEC regulation.

As mentioned above, there are important exceptions to this general requirement of SEC regulation that apply to bank securities activities conducted in connection with traditional banking activities. Activities falling within the exceptions could still be conducted in the bank subject to regulation by the appropriate banking regulator. These exceptions include, among others:

- most trust account securities activities, so long as the bank does not solicit brokerage business and receive incentive compensation;

- "networking arrangements," where a bank contracts with a registered broker-dealer (whether or not affiliated with the bank) to provide brokerage services on bank premises on a fully disclosed basis;

- transactions in U.S. Government securities, commercial paper, bankers acceptances, and (if the bank's holding company does not have a new securities affiliate) municipal securities;

- primary private placement activities for certain institutional investors and wealthy individuals; and

- up to 1,000 securities transactions that are not otherwise exempt if the bank does not have a registered broker-dealer subsidiary or affiliate.

DEALING ACTIVITIES

Title III amends the "dealer" definition in a manner similar to the "broker" definition. A bank's dealing activities will be regulated by the SEC unless they fall within one of four exceptions: (1) dealing activities in connection with trust or fiduciary activities; (2) dealing in U.S. Government securities, commercial paper, bankers

acceptances, and commercial bills; (3) dealing in municipal securities if the bank does not have a securities affiliate under section 4(c)(15) of the Bank Holding Company Act; and (4) dealing in certain securities secured by obligations originated or purchased by the bank, its affiliates, or its subsidiaries.

The provisions of this title are not intended to subject the broker-dealer activities of a bank to significant overlapping regulation by the SEC and the Federal banking regulators. To the extent that the broker-dealer activities of a bank are subject to SEC regulation, these activities will be conducted in a subsidiary of the bank or in an affiliate of the bank pursuant to section 4(c)(8) or 4(c)(15) of the Bank Holding Company Act. The subsidiary or affiliate, and not the bank itself, would then be subject to the same registration and regulatory requirements as are applicable to other broker-dealers under the Exchange Act.

TITLE IV—BANK INVESTMENT COMPANY ACTIVITIES

Title IV applies functional regulation to bank investment company activities in much the same way that Title III applies functional regulation to broker-dealer activities. ("Investment companies" include mutual funds, closed-end investment companies and unit investment trusts.)

Other provisions of the bill permit bank securities affiliates to underwrite and distribute the securities of investment companies. As banking organizations exercise this new authority, they are also likely to increase their already substantial investment advisory activities. It is therefore appropriate for the SEC to regulate bank investment company activities in the same way that it regulates similar activities engaged in by nonbanking companies, but with due deference to existing supervision by Federal banking regulators.

Title IV accomplishes this result with amendments to both the Investment Company Act of 1940 and the Investment Advisers Act of 1940 ("Advisers Act"). The SEC, the Federal Reserve Board, the Comptroller of the Currency, and the FDIC all endorse these amendments.

INVESTMENT COMPANY AMENDMENTS

The Investment Company Act governs, among other things, transactions and relationships between registered investment companies and their affiliates. Title IV's amendments to the Act are intended to address the issues that arise where investment companies affiliate with banking organizations. The amendments would, among other things:

- prohibit an investment company from borrowing from an affiliated bank, except in accordance with SEC rules;
- limit the extent to which bank or holding company officials could serve as directors of an affiliated investment company;
- prohibit investment companies affiliated with banks from suggesting that their securities are federally insured;

—prohibit an investment company from knowingly purchasing securities being underwritten to repay a loan from an affiliated bank; and

.provide the SEC with authority to establish rules for the custody of an investment company's assets by a bank that is affiliated with the investment company's sponsor.

INVESTMENT ADVISER AMENDMENTS

The Advisers Act currently excludes banks and bank holding companies that act as investment advisers from the registration and other requirements of that Act. Under Title IV the exclusion is repealed, but a bank would not have to form a separate company to register as an investment adviser, and neither would it be subject to dual regulation by the SEC and the appropriate Federal banking agency. Instead, the bank would have the option of conducting its advisory activities through a separate department or division that would itself register as an investment adviser. Only this separate department or division would be subject to SEC regulation and supervision.

Moreover, the amendments to the Advisers Act minimize duplicative and overlapping regulation by requiring the SEC and the Federal banking agencies to share examination reports of bank investment advisory activities and to coordinate enforcement of the regulations governing such activities. It is expected that the SEC and the Federal banking agencies will cooperate in such efforts while minimizing the regulatory burden on banks.

Finally, nothing in this title or any other provision of the bill is intended to prevent a registered broker-dealer subsidiary or affiliate of a bank, or a bank engaged in a "networking" arrangement, from executing customer orders for shares of a mutual fund for which the bank's section 4(c)(15) securities affiliate serves as principal underwriter or investment adviser.

TITLE V—STRENGTHENED ENFORCEMENT AUTHORITY

Concomitant with the granting of new powers to depository institutions and bank holding companies, this bill also provides the regulatory agencies with the enhanced enforcement powers necessary to police the exercise of these powers and to ensure the continued safety and soundness of the financial system.

The provisions of this title stem from a legislative proposal submitted by the Federal Deposit Insurance Corporation, the Federal Reserve Board, the Office of the Comptroller of the Currency, the Federal Home Loan Bank Board, and the National Credit Union Administration Board. This proposal was introduced, at the request of these agencies, by Senators Proxmire and Garn in the 100th Congress as S.1974. A modified version of this proposal has been incorporated by the Committee in this bill as title V.

The last significant revision of the Federal banking agencies' enforcement powers was in 1978. In that year, Congress enacted the Financial Institutions Regulatory and Interest Rate Control Act (FIRA). That statute granted the agencies some important new powers, including the power to assess a civil money penalty for violations of a final cease and desist order.

Since the adoption of FIRA, the agencies enforcement powers are for the most part adequate. But in some instances the powers need to be strengthened or clarified in order to be more effective. In particular, it is necessary to resolve several problems caused by court decisions which have hindered or could hinder the agencies' abilities to use their enforcement tools effectively.

Title V specifies that the agencies have the authority to order affirmative actions, including reimbursement, indemnification, or restitution, whether or not the party involved was personally enriched by his actions, and by providing that the statutory enforcement powers given the agencies are cumulative in nature, not exclusive.

These amendments are designed to clarify several other areas where the agencies powers are now in doubt, and will codify certain administrative interpretations and procedures already in use at the agencies. Finally, these provisions ensure that the enforcement powers of all of the financial institution regulatory agencies are as identical and complementary as possible, and that the wide variety of financial institutions supervised by these agencies and individuals who work for them are subjected to the same laws and penalties for the same transgressions.

Finally, with respect to the review of enforcement actions, the Committee believes that it is important for the Federal Home Loan Bank Board to formalize a policy regarding the review of cease-and-desist and removal orders. This policy should provide that final cease-and-desist orders shall be reviewed by the agency upon petition, not later than 2 years after issuance of the order. Final removal orders should be reviewed by the agency, upon petition, not less than 5 years after issuance of the order. No formal or informal hearing need be included in such a review.

TITLE VI—TRUTH IN SAVINGS AND INVESTMENTS

Title VI of the bill is the "Truth in Savings and Investments Act." Its provisions are designed to enable consumers to compare different savings and investments products so that they can make informed decisions as to where to invest their money.

Prior to 1980, it was relatively easy for consumers to compare different deposit accounts because strict Federal regulation permitted very little variation in terms and conditions.

As banking deregulation has proceeded during the 1980's, depository institutions have been free to offer not only a broader range of interest rates, but entirely new instruments with widely varying terms and conditions. As Alan Fox, Legislative Representative of the Consumer Federation of America, testified, "This transformation of the market for financial services has benefitted those consumers with adequate resources to take advantage of their new options. For most consumers, however, the expansion of options has not been matched with the expansion of information necessary to evaluate options and make informed choices."

The problems—and opportunities—for consumers have been further complicated by the rise of alternative investment products. With the interest rates on deposit accounts still regulated in the late 1970's and early 1980's, consumers shifted large amounts of

their savings to money market mutual funds, which were not subject to Government regulation. While such funds were providing higher returns than most short term depository institution instruments, they were not directly comparable to deposit accounts because they were not covered by Federal deposit insurance and did not guarantee a future rate of return (instead, they were able to provide yield data reflecting past performance).

S. 1507, introduced on July 21, 1987, by Chairman Proxmire and Senators Dodd and Heinz, was designed to address the problems of nonstandardized terms among deposit accounts, as well as the failure of depository institutions to disclose relevant conditions. Chairman Proxmire also indicated his desire to have the legislation address mutual funds. The bill requires the disclosure of key terms in all advertisements, and a more comprehensive list of terms and conditions in specific schedules.

On August 5, 1987, the Consumer Affairs Subcommittee held a hearing, at which the following witnesses testified: Howard B. Brown, Commissioner of Banking, the State of Connecticut; Theo Pitt, Jr., Vice Chairman, United States League of Savings Institutions; Alan Fox, Legislative Representative, Consumer Federation of America; Jack Shipman, Executive Vice President, Liberty National Bank and Trust, on behalf of the American Bankers Association; David Silver, President, the Investment Company Institute; and Dan Goelzer, General Counsel, the Securities and Exchange Commission.

Commissioner Brown cited positive experience with similar legislation in Connecticut and supported passage of S. 1507.

Alan Fox emphasized the importance of consumers having standardized and complete information for the marketplace to operate efficiently. He pointed out that consumers are often not given such relevant information as "the basis of compounding, whether the interest is paid on an average or low balance, any minimum balance required to receive interest, and how the minimum balance is calculated." Without such information, consumers cannot compare yields on deposit accounts. Further, he noted "the difficulties of comparing time deposits of varying maturities and accounts that offer different rates of interest on different amounts or over the life of the deposit, or that vary the rate of interest to reflect market changes." Moreover, he noted that these considerations do not even address the range of service fees that can be imposed.

Mr. Fox expressed specific concern about bank use of the "investable balance" method, whereby banks pay the disclosed rate of interest on only a portion of the account, usually citing the need to put a certain portion into reserves for the Federal Reserve System. He also cited a 1975 *Consumer Reports* that revealed that the same interest rate can produce returns on the same balances that vary from \$44.93 to \$75.30, depending upon whether one uses a low balance method or a day of deposit to day of withdrawal method. Mr. Fox called for comprehensive disclosure, the use of a standardized balance calculation method, and a ban on the use of the investable balance method.

Both depository institutions representatives supported the intent of S. 1507 but called on the Committee to apply analogous provi-

sions to all mutual funds, pointing out that consumers view mutual funds as competitors for the same dollars.

Mr. Silver cited the SEC regulations for money market mutual funds and their proposed regulations for all mutual funds. Further, he endorsed enactment of S. 1507 and specifically called for adoption of an amendment to require the Federal Reserve Board and the SEC "to consult for the purpose of coordinating and harmonizing their regulatory efforts."

Finally, Mr. Goelzer testified that "Based upon the success of the standardization of advertised money market yields, the Commission has proposed rules to require the standardization of performance data for open-end management investment companies that are not money market funds." In light of the proposed rule, Mr. Goelzer argued that "amendment to S. 1507 to include investment companies is not necessary."

As a result of the hearings, the bill was revised and then included as Title VI of S. 1886.

Title VI requires the disclosure, in solicitations by depository institutions, of basic information about yields and fees. Among other things, it requires the disclosure of the annual percentage yield, the period it will be in effect, any minimum account balance and time requirements, the minimum amount of the initial deposit, a Statement that regular fees or other conditions could reduce the yield, and a Statement of any penalty imposed for early withdrawal.

Title VI also requires each depository institution to maintain a detailed schedule of fees, charges, yields, and other terms and conditions. It requires the use of the average daily balance method, "which is the sum of each day's closing balance divided by the number of days in the period," and requires interest to be calculated on the full amount of the principal in the deposit account. This provision prohibits the use of the investable balance method.

Finally, Title VI does not require directly comparable disclosures for mutual funds, in recognition of the recently adopted SEC regulation. The Committee believes that regulation is adequate to enable consumers to compare savings and investments products. To assure that such will be the case in the future, the title requires the Federal Reserve Board and the SEC to review the regulations annually "to determine whether such regulations are providing consumers the ability to effectively compare savings and investments options." If that should ever not be the case, then the SEC will be obligated to modify its regulations to achieve that goal.

TITLE VII—HOME EQUITY LOANS

BACKGROUND

Title VII of the bill is the "Home Equity Loan Consumer Protection Act of 1988."

The Tax Reform Act of 1986 started the phasing out of the tax deductibility of interest for non-mortgage consumer debt. As a direct result of the legislation, home equity loans have become an enormously popular device for consumers to use in order to continue to be able to deduct interest payments. As Martha Seger, Gover-

nor, the Federal Reserve System, testified at the November 18, 1987, hearing of the Subcommittee on Consumer Affairs:

There has been a substantial growth in this type of credit since 1984, with outstanding balances totaling approximately \$40 billion at the end of 1986. We believe that the total may now be as high as \$70 billion and could reach \$80 billion by year-end.

The home equity loan has obvious advantages for consumers over other forms of credit, including tax deductibility, the use of revolving lines of credit, repayment periods of up to 15 years, and lower interest rates than other loans (because they are secured by the borrower's home).

At the same time, there are significant potential dangers associated with these loans. First and foremost is the basic fact that a home equity loan is secured by a person's home and any inability to repay the loan—whether it is caused by a runup in interest rates, a death in the family or unexpected major medical expenses—could cause the borrower to lose his or her home.

Recent history reminds us that a rapid increase in interest rates is not beyond the realm of the possible. For example, if one takes the median amount of credit outstanding on a home equity loan today—\$25,000—and assume the typical index of prime plus 1½ percent, then the borrower would be paying about \$2,500 in interest during the course of a year. However, if the prime were to rise to its 1981 high of 20.5 percent, then the consumer's yearly interest bill would double to \$5,000. Many families would find it difficult to meet these higher payments, especially if they were not fully aware of the potential increase when they took out the loan.

An even more immediate threat to the consumer lies in a provision commonly contained in home equity loans that gives the lender the right to change any term or condition unilaterally. Pursuant to such a provision, a lender could choose, for example, to change the index on a variable rate loan to one that is more costly to the consumer, or to raise the margin between the index and the rate charged by a point or two. While such provisions are typical in open-end credit contracts, home equity loans are different because consumers normally pay closing costs to secure them and because the consumer's home is at stake in the event of a default.

In response to these concerns and other, the Subcommittee on Consumer Affairs held a hearing on November 18, 1987, at which the following witnesses testified: Congressman David E. Price; Congressman Charles E. Schumer; Martha Seger, Governor, the Federal Reserve Board; a panel of consumer witnesses consisting of Alan Fox, on behalf of the Consumer Federation of America, Jack Guildroy, on behalf of the American Association of Retired Persons, and Neil Fogarty, on behalf of the Consumers League of New Jersey; and a panel of lenders, including William T. Kirkpatrick, on behalf of the American Bankers Association, H. Earle Ferguson, Jr., on behalf of the Consumer Bankers Association, and Thomas D. Harman, on behalf of Merrill Lynch Equity Management, Inc.

Congressman Price, the author of H.R. 3011, the Home Equity Loan Consumer Protection Act of 1987, argued for additional disclosures at an early point in the process, citing four examples of

lender advertisements that promoted different favorable features of their plans but did not disclose other key elements. Further, he noted that present law requires comprehensive disclosure only when the credit is extended to the consumer, a time that prevents the consumer from being able to comparison shop.

Congressman Schumer, the author of H.R. 3468, the Home Equity Loan Disclosure Act of 1987, supported not only more comprehensive and more timely disclosures but a series of restrictions on contract terms to eliminate what he called "Rate Rise Surprise" and "Surprise Balloon Payments." Thus, his bill would limit the increase in interest rates to 2 percent per year, outlaw interest only payments, and make it illegal to call a loan before maturity unless the borrower has been delinquent.

Governor Seger supported the need for fuller and more timely disclosure, particularly in light of the possibility of losing one's home, and for the use by lenders of independent indices, but opposed restricting the lender's unilateral right to change terms and conditions.

The consumer representatives all stressed the need for better disclosure, particularly given the fact that the consumer could lose his or her house in the event of a foreclosure. Alan Fox also stressed the need to include some provisions to "reflect a fair allocation of rate risk between the lender and the borrower." He noted specifically the fact that most home equity loans are variable rate products and contain no limit on how rapidly rates can rise, other than a lifetime limit. He also called for a number of substantive restrictions, including a prohibition on the ability of lenders unilaterally to change contract terms and a requirement that lenders use indices that are outside their control.

The lender representatives opposed substantive restrictions but supported disclosure legislation. As Mr. Kirkpatrick testified on behalf of the American Bankers Association, "we support legislation which provides for reasonable disclosures of pertinent features of home equity financing products." Mr. Harman of Merrill Lynch testified about how his company deals with changes in terms. He says that under such circumstances, the borrower is given advance notice and "If the borrower does not wish to accept the proposed change, the borrower can draw down as much of the credit line as he or she desires within a specified time frame. . . ." The funds outstanding would then be governed by the original terms.

COMMITTEE ACTION

As a result of the hearing, a bill was drafted and then included as Title VII of S. 1886.

Title VII has two main parts. The first involves a detailed set of key terms and conditions that must be disclosed at the time an application form is provided or not less than 3 business days before the consumer incurs a nonrefundable fee, whichever is earlier. The second involves four specific restrictions on contract terms: (a) the creditor may not make unilateral changes in the terms after an agreement has been entered into, except that the creditor may change the index if the change would at all times thereafter result in more favorable rates of interest for the consumer; (b) the credi-

tor must use an index for changing terms that is not within the creditor's immediate control (e.g., the lender may not use its own prime rate) and that is readily available to the general public; (c) if any term contained in the key disclosures changes and, as a result, the consumer elects not to enter into an agreement, the creditor must refund all fees and costs paid in connection with the application for the loan; and (d) a creditor may not unilaterally terminate a home equity loan except in the case of fraud or material misrepresentation by the consumer, failure by the consumer to meet the repayment terms, or any action or inaction by the consumer which adversely affects the creditor's security interest.

The Committee believes that the disclosure provisions will increase consumers awareness of the benefits and risks associated with home equity loans and enable them to shop around for the best deal. The four restrictions should provide a better balance between creditor protection (which can be assured in the initial contract, most obviously through the use of a variable rate keyed to changes in the creditor's cost of money), and consumer protection, which can best be assured by guaranteeing that consumers will get what the contract says they are entitled to.

TITLE VIII—INSURANCE ACTIVITIES

This title establishes the ground rules for bank insurance activities under both the Bank Holding Company Act of 1956 and the National Bank Act. The title would not affect the right of States to permit freestanding State-chartered banks, those not affiliated with bank holding companies, to engage in any activities the States authorize. With respect to banks and bank subsidiaries that are parts of holding companies, State law would determine their permissible insurance activities so long as the operations of the holding companies' banking subsidiaries are principally conducted in that State and the insurance activities are conducted within that State. With respect to national banks, the title limits their insurance activities to credit insurance and insurance activities conducted in a place of 5,000 or fewer residents for residents and employees of that State.

BACKGROUND

Insurance Activities of State Bank Subsidiaries of Bank Holding Companies

Section 4(c)(8) of the Bank Holding Company Act provides the Federal Reserve Board with the discretion to authorize bank holding companies to engage in activities "so closely related to banking or managing or controlling banks so as to be a proper incident thereto. . . ." Pursuant to this authority, prior to 1982, the Board had allowed bank holding companies to engage in two limited types of insurance activities: the underwriting and sale of credit-related insurance, including credit-related property and casualty insurance; and the general brokerage of insurance in places with a population not exceeding 5,000, so long as the bank holding company was itself located in such place.

Then, Title VI of the Garn-St Germain Depository Institutions Act of 1982 amended section 4(c)(8) to delineate permissible insurance activities for bank holding companies. In brief, Title VI limits

the permissible insurance activities of bank holding companies to the underwriting and sale of credit life, credit disability, and credit unemployment insurance; certain credit-related insurance sold by finance company subsidiaries of bank holding companies; insurance agency activities in places of 5,000 or fewer; and certain insurance agency activities by bank holding companies whose total assets are less than \$50 million.

The Garn-St Germain Act also contained two clauses grandfathering certain insurance agency activities. Exemption (D) grandfathered any insurance agency activity engaged in by the bank holding company or any of its subsidiaries on May 1, 1982. Such activities may take place in the holding company's State, any States immediately adjacent to such State, and States where the activity took place on the grandfather date.

Exemption (G) of that Act also grandfathered the pre-1971 insurance agency activities of 16 bank holding companies, without geographic restrictions.

Shortly after the Garn-St Germain Act was enacted, the State of South Dakota adopted legislation permitting State banks to engage in general underwriting and insurance activities and permitting out-of-State bank holding companies to acquire a single existing State-chartered South Dakota bank. However, if an out-of-State company acquired a South Dakota bank, it could direct its insurance activities to out-of-State residents only.

Thereafter, in applying to the Board to acquire South Dakota banks under the new law, several bank holding companies argued that such acquisitions would be legal under the Bank Holding Company Act because the recently-enacted provisions of the Garn-St Germain Act limiting insurance activities applied only to the insurance activities of bank holding companies and their *nonbanking* subsidiaries; not to the activities of their banking subsidiaries.

Since then, the Board and the courts have been wrestling with the meaning of the Act, and the Congress has been struggling to resolve the policy questions.

First, in 1984, the Senate passed S. 2851, the Financial Services Competitive Equity Act, which included a provision that would have amended the language of section 4(c)(8) to apply to bank holding companies "and any subsidiary or affiliate thereof." The effect would have been to limit the insurance activities of the bank holding company and all of its banking and nonbanking subsidiaries to those permitted by section 4(c)(8). However, the House did not adopt any banking legislation in that Congress, so S. 2851 died.

Next, in 1985, the Board denied Citicorp's application to acquire a South Dakota State-chartered bank on the ground that the South Dakota institution would be operated not as a *bona fide* "bank," but instead as a nonbanking subsidiary engaged in the nationwide sale of insurance. The application was therefore held to be an impermissible attempt to evade section 4(c)(8). See *Citicorp*, 71 Fed. Res. Bull. 789 (1985).

However, the Board did not reach the issue of whether *bona fide* State-chartered banks engaged in general insurance activities could ever become subsidiaries of holding companies without violating section 4(c)(8).

Before any further regulatory action took place, the Congress once again entered the fray. This time, in the Competitive Equality Banking Act of 1987 ("CEBA"), the Congress imposed a moratorium on the Federal bank regulators taking any action to increase the insurance powers of bank holding companies that would become effective before the expiration of the moratorium. The moratorium went into effect as of March 5, 1987, with an expiration date of March 1, 1988.

Despite the moratorium, in September, 1987, the Board ruled that section 4 does *not* apply to State bank subsidiaries of bank holding companies. *Merchants National Corp.*, 73 Fed. Res. Bull. 876 (Sept. 10, 1987). Thereafter, the U.S. Court of Appeals for the Second Circuit overturned the case on the grounds that the Board's decision violated the moratorium on regulatory action imposed by CEBA. *Independent Insurance Agents of America v. Board of Governors*, 83S F.2d 627 (2d Cir. 1988). However, the underlying issue concerning the applicability of section 4(c)(8) to bank subsidiaries was not resolved.

One other issue has arisen under the Bank Holding Company Act—the issue of whether bank holding companies engaged in grandfathered insurance activities under exemptions (D) and (G) of section 4(c)(8) may transfer those rights to acquiring bank holding companies. The Board has dealt with those issues differently. It has not permitted such transfers for the exemption (G) companies but has authorized the transfer and extension of grandfathered insurance activities under exemption (D). The legality of the Board's rulings is being challenged.

Insurance Activities of National Banks

National banks that are not part of bank holding companies may engage directly or through subsidiaries in insurance activities to the extent permitted by Federal statute.

Under the National Bank Act, national banks are permitted to exercise "all such incidental powers as shall be necessary to carry on the business of banking." 12 U.S.C. §24(7). In the past, attempts to use this provision to authorize national banks to engage in full scale insurance agency activities have been rebuffed by the courts. See, e.g., *Saxon v. Georgia Association of Independent Insurance Agents*, 399 F. 2d 1010 (5th Cir., 1968). However, the courts have allowed national banks to underwrite and sell credit-related life, health, and accident insurance. *Independent Bankers Association v. Hermann*, 613 F. 2d 1164 (D.C. Cir. 1980). Moreover, during the last 2 years, the Comptroller has interpreted the incidental-to-banking provision as authorizing national banks to sell and underwrite title and municipal bond insurance. These interpretations are the subject of ongoing court challenges.

In addition, the National Bank Act authorizes national banks to engage in general insurance agency activities in places of 5,000 or fewer. 12 U.S.C. §92. In the summer of 1986, however, the Comptroller issued a written opinion that would permit a national bank to use a small town branch to sell insurance on an agency basis nationwide. OCC Staff Interpretive Letter No. 366 (Aug. 18, 1986). This interpretation, which is known as the "Comptroller's loophole," is currently being challenged in the courts.

Permissible Insurance Activities Under the Legislation

During consideration of the Committee Print, an amendment was adopted that is designed to establish legislative groundrules for the relationship between banking and insurance.

This title reflects that amendment. It establishes a comprehensive framework to resolve the issues that have arisen with respect to both State-chartered banks that are parts of bank holding companies and national banks.

With respect to the Bank Holding Company Act, the title establishes the general principle that a bank holding company or any bank or nonbank subsidiary or affiliate thereof may engage in insurance activities only to the extent permitted by State law and then only within the "home State" of the bank holding company.

The "home State" of the bank holding company is defined to mean the one State in which the total amount of deposits held by all of the bank subsidiaries of the holding company was largest on May 9, 1956, or on the date the company became a bank holding company, whichever is later. The home State cannot change, even if at a later time the bank deposits in another State become larger than the bank deposits in the home State.

In addition, the insurance may be provided only "to residents of that State, natural persons employed in that State, or natural persons otherwise present in that State." With the exception of the situations outlined below, the effect of this rule is to limit the impact of a State law authorizing insurance activities for banks to only one State. The provision will prevent bank holding companies from acquiring banks in several large States and thus selling or underwriting insurance to a large percentage of the American population.

Notwithstanding the general rule, the title authorizes a bank holding to continue to engage in any insurance activity through a State bank or subsidiary thereof if the bank was acquired after December 31, 1984 and before March 2, 1988, pursuant to Board approval, so long as the insurance activities are authorized by State law, the bank provides insurance only to residents of that State, natural persons employed in that State, or natural persons otherwise present in that State, and such insurance insures against the same types of risks or functionally equivalent risks. The latter proviso would, for example, permit a bank that was selling one type of life insurance to sell another type of life insurance, but it would not permit the bank to sell property/casualty insurance products if it had not been doing so. Similarly, the past sale of credit life insurance would not permit a bank to sell any other forms of insurance in the future.

This grandfather exception applies to the following situations: (1) NCNB Corp's acquisition of Bankers Trust of South Carolina; (2) Citicorp's acquisition of Great Western Bank & Trust of Phoenix, Arizona; (3) Sovran Financial Corporation's acquisition of Suburban Bank of Bethesda, Maryland; (4) Standard Chartered PLC & Union Bancorp of Los Angeles, California, acquisition of United Bancorp of Arizona; (5) Trustcorp, Inc. of Toledo, Ohio, acquisition of St. Joseph Bancorp of South Bend, Indiana, and of Salem Bank & Trust Co. of Goshen, Indiana; (6) Banc One Corporation's acquisi-

tion of American Fletcher of Indianapolis, Indiana; (7) Ameritrust of Cleveland, Ohio, acquisition of Legoniere Bank of Legoniere, Indiana; (8) First of America Bank Corporation of Kalamazoo, Michigan, acquisition of First Bank & Trust of Speedway, Indiana; (9) National Bank of Detroit of Detroit, Michigan, acquisition of Midwest Commerce Banking Company of Elkart, Indiana; and (10) Dominion Bankshares Corp. of Roanoke, Virginia, acquisition of Dominion Bank of Middle Tennessee, of Nashville, Tennessee.

The bill also provides for an exception for a bank holding company that provides "title insurance coverage through a State bank or subsidiary thereof if the bank was required to be empowered to provide title insurance as a condition of its initial chartering under State law." This exception addresses the unique situation of Meridian Bancorporation, which is underwriting and selling title insurance in 45 States.

The title also addresses the matter of transfers of grandfathered insurance activities under exemption (D) of section 4(c)(8). It prohibits any transfer of such rights after March 2, 1988, to any bank holding company other than a holding company that has and continues to have, total assets of \$50 million or less. The only exception is for transfers to a corporate successor.

With respect to transfers of exemption (D) rights that took place prior to March 2, 1988, such transfers would remain in effect if the transfer is determined by the courts to be legal under the Bank Holding Company Act. The Committee expresses no opinion, one way or the other, as to the legality of such transfers under the Act. The purpose of this provision is simply to uphold such transfers if the courts find they were legally consummated.

As indicated previously, the Board has ruled that exemption (G) rights may not be transferred, so there is no issue for the legislation to address. At the same time, the Committee expresses no opinion, either way, as to the legality of the Board's ruling on exemption (G) transfers.

The title also establishes groundrules for insurance activities for national banks. First, the title sets forth insurance powers a national bank may engage in, limiting them to insurance that "is limited to assuring the repayment of the outstanding balance due on any specific extension of credit by the national bank in the event of the death, disability, or involuntary unemployment of the debtor. . . ." The bill, however, does permit Citicorp to continue to conduct its municipal bond guarantee insurance activities, so long as the courts finally determine such activities to be legal under the National Bank Act. As with the issue of the legality of transfers of grandfathered insurance rights under the Bank Holding Company Act, the Committee expresses no opinion either way as to the legality of these activities under present law. That is a matter for the courts.

By limiting national banks to credit insurance activities, the Committee specifically overturned the Comptroller of the Currency's interpretive ruling that authorized national banks to enter the title insurance business as either agent or insurer and to underwrite and sell municipal bond insurance. Therefore, national banks and their subsidiaries are subject to same prohibitions and limita-

tions with regard to title insurance as are provided under this title for other types of insurance activities.

Finally, the title closes the so-called "Comptroller loophole" by restricting the ability of national banks to sell insurance in a place with a population not exceeding 5,000. A national bank located in such a place may sell insurance so long as such insurance activities are confined to that place and, in addition, the insurance is sold only to residents of the State, including corporate residents, and national persons employed in the State.

TITLE IX—MISCELLANEOUS PROVISIONS

Section 901 of this title requires the Federal Reserve Board, in consultation with the Attorney General, the Comptroller General and the FDIC, to study the effects of hostile acquisitions in the banking industry on the safety and soundness of our financial system. Section 902 provides that "nonbank banks" controlled by bank holding companies on August 10, 1987, may not accept transaction accounts, or make commercial loans, unless authorized to do so by the Federal Reserve Board as of August 10, 1987. Section 903 liberalizes the joint marketing restrictions on nonbank banks controlled by commercial firms. Section 904 provides that an industrial bank exempt from the definition of a "bank" under the Bank Holding Company Act, may engage in activities either engaged in or authorized to be engaged in as of March 5, 1987. Section 905 provides that a certain investment company incorporated on March 29, 1985, shall be deemed to have registered under the Investment Company Act as of the date of its incorporation.

FINANCIAL MODERNIZATION ACT OF 1988

SECTION-BY-SECTION ANALYSIS

SECTION 1. SHORT TITLE; TABLE OF CONTENTS

This section designates the bill as the "Financial Modernization Act of 1988" and also provides a table of contents for the bill.

TITLE I.—SECURITIES AFFILIATES OF BANK HOLDING COMPANIES

SECTION 101. AMENDMENTS TO THE BANKING ACT OF 1933

This section repeals sections 20 and 32 of the Banking Act of 1933. (Sections 16, 20, 21, and 32 of that Act are commonly known as the Glass-Steagall Act.)

Section 20 prohibits a bank that is a member of the Federal Reserve System ("member bank") from being affiliated with any company that is "engaged principally in the issue, flotation, underwriting, public sale, or distribution" of securities. 12 U.S.C. § 377.

Section 32 prohibits an officer, director, or employee of a company that is "primarily engaged in the issue, flotation, underwriting, public sale, or distribution" of securities from serving at the same time as an officer, director, or employee of a member bank. 12 U.S.C. § 78.

The bill makes no change in section 21, which prohibits any entity "engaged in the business of issuing, underwriting, selling, or distributing" securities (except to the extent permissible for a national bank under section 16) to "engage at the same time to any extent whatever in the business of receiving deposits." 12 U.S.C. § 378(a)(1). Section 21 applies to all deposit-taking entities, including thrift institutions and nonmember banks.

The only change in section 16 (12 U.S.C. § 24 (Seventh)), which limits securities underwriting, dealing, and investment by national banks, is that made by section 108 of the bill.

SECTION 102. AUTHORIZATION FOR BANK HOLDING COMPANIES TO ACQUIRE SECURITIES AFFILIATES

This section amends the Bank Holding Company Act of 1956 to establish a framework for affiliations between banks and securities firms.

A. Powers of a Securities Affiliate

1. Securities activities

Subparagraph (A) permits a securities affiliate to engage, subject to other provisions of section 4(c)(15), in any combination of the following activities:

(1) underwriting, distributing, or dealing in securities of any type (subject to subparagraphs (I) and (K), which are described below);

(2) securities brokerage, private placement of securities, investment advisory activities, or other securities activities permitted for brokers or dealers registered under the Securities Exchange Act of 1934 or for investment advisers registered under the Investment Advisers Act of 1940; or

(3) other nonbanking activities permitted under section 4 of the Bank Holding Company Act for bank holding companies or their nonbanking subsidiaries, if the securities affiliate obtains any approval that may be required under the appropriate provisions of section 4.

Under subparagraph (K), authority to underwrite, distribute, or deal in investment company securities and certain corporate debt securities is delayed until 180 days after the bill becomes law, and authority to underwrite, distribute, or deal in equity securities (other than investment company securities) is contingent on a separate congressional vote to be held in 1991 pursuant to section 113 of the bill. Under subparagraph (I), moreover, a securities affiliate may not begin to underwrite, distribute, or deal in certain corporate debt securities or equity securities unless the securities affiliate's affiliated banks are in compliance with any applicable risk-based capital standards.

Brokerage execution, with or without investment advice, does not constitute "underwriting, distributing, or dealing" for purposes of subparagraph (A)(i), for a broker does not act as a principal or make a public offering on behalf of an issuer. See *Securities Industry Association v. Board of Governors*, 821 F.2d 810, 814-15 (D.C. Cir. 1987), cert. denied, 108 Sup. Ct. 697 (1988). Subparagraph (J)(iv) specifically provides that "dealing" does not include purchasing or selling securities for the account of another person (e.g., brokerage). Accordingly, discount or full-service brokerage may continue to be conducted under section 4(c)(8)—even though subparagraph (G) requires underwriting, distribution, and dealing to be authorized or reauthorized under section 4(c)(15). The same is true of other securities activities enumerated in subparagraph (A)(ii), except to the extent that such an activity may constitute underwriting, distribution, or dealing.

Subparagraph (A)(i) contains no reference to "issuing" securities because none is necessary. If a securities affiliate issues securities in the ordinary course of its existence as a corporation (e.g., to its parent bank holding company), it does so under its charter powers, rather than under subparagraph (A). No reference to "issuing" is needed in order for a securities affiliate to engage in underwriting that may incidentally make the securities affiliate an "issuer" for purposes of the securities laws (e.g., securitizing assets through a trust controlled by the underwriter, which purchases the assets and issues securities representing interests in the assets). Nor is a reference to "issuing" needed in order for a securities affiliate to be affiliated with an investment company in a manner permissible under the securities laws; the authority granted by subparagraph (A)(i)-(ii) is sufficient for purposes of the Bank Holding Company Act. Although "issue" or "issuing" appears in sections 20, 21, and

32 of the Glass-Steagall Act, there is no reason to perpetuate any possible confusion by reiterating such language.

Likewise, although "flotation" and "public sale" appear in sections 20 and 32, there is no need to repeat them in subparagraph (A)(i); they add nothing to "underwriting, distributing, or dealing in."

2. Nonsecurities activities

Under subparagraph (A)(iii), a securities affiliate may engage in nonsecurities activities that are otherwise permissible under section 4 of the Bank Holding Company Act (e.g., leasing, mortgage banking, management consulting, financial counseling, selling money orders, or dealing in precious metals). If a securities affiliate wishes to engage in a permissible nonsecurities activity pursuant to subparagraph (A)(iii), or to acquire shares of a company engaged in such an activity, the securities affiliate must follow any application, notice, or other approval procedure prescribed under section 4.

Subparagraph (A)(iii) is intended to avoid imposing needless constraints on how bank holding companies structure their nonbanking operations. However, subparagraph (A)(iii) cannot be used to circumvent section 21 of the Glass-Steagall Act, which prohibits a company that underwrites ineligible securities from accepting deposits. Accordingly, subparagraph (A)(iii) does not authorize a bank holding company to use a deposit-taking institution (e.g., a thrift institution or an industrial loan company) as a vehicle for underwriting ineligible securities.

B. Application Requirements

Subparagraph (B) sets forth the standards and procedures applicable to a bank holding company that seeks to acquire shares of a securities affiliate under section 4(c)(15). All such acquisitions are subject to subparagraph (B), with one exception: if a bank holding company has already acquired control of a securities affiliate under subparagraph (B) and seeks to make an additional equity investment, the transaction is governed by subparagraph (D)(ii) (described below).

A bank holding company cannot evade section 4(c)(15) by structuring its acquisition of a securities affiliate as a purchase of assets. A bank holding company that seeks to acquire all or substantially all of the assets of a company engaged in nonbanking activities must obtain the Board's approval under section 4 of the Bank Holding Company Act in the same manner as if the bank holding company were acquiring the voting shares of that company. See 12 C.F.R. § 225.21(a). Thus a bank holding company must obtain the Board's approval under section 4(c)(15) in order to acquire all or substantially all of the assets of a company engaged in underwriting, distributing, or dealing in securities (except insofar as section 4(c)(15)(G)(ii) permits the Board to authorize such activities under section 4(c)(8)).

1. Application procedure

During the first four years after the bill is enacted, a bank holding company must file an application and obtain the Federal Re-

serve Board's approval before acquiring shares of a securities affiliate under section 4(c)(15) (except for acquisitions under subparagraph (D)(ii)). In acting on the application, the Board is to apply the net-public-benefits test of section 4(c)(8), under which the Board weighs the anticipated public benefits of the proposed acquisition (such as increased competition, greater convenience, or gains in efficiency) against possible adverse effects (such as undue concentration of resources, decreased or unfair competition, conflicts of interest, or unsound banking practices). Even if the acquisition meets that test, the Board may not grant approval unless it is satisfied that the bank holding company has the managerial resources to conduct the proposed activities safely and soundly.

2. Notice procedure

Section 203 of the bill replaces the current application procedure under section 4(c)(8) with a notice procedure. Beginning four years after the bill is enacted, that notice procedure will also apply to acquisitions under section 4(c)(15). Such acquisitions will be evaluated under the net-public-benefits test of section 4(c)(8).

3. Reliance on SEC's expertise in evaluating financial and managerial resources

The Committee intends that the Board, in acting on applications or notices under subparagraph (B), abide by the principle of functional regulation. Specifically, the Board should rely on the expertise of the Securities and Exchange Commission ("SEC" or "Commission") in determining the adequacy of the managerial and financial resources of a proposed securities affiliate. Thus, if the Commission determines that the securities affiliate meets all of the requirements to be registered as a broker or dealer under the Securities Exchange Act, or as an investment adviser under the Investment Advisers Act, the Board should not prevent the proposed acquisition on the ground that it believes the managerial or financial resources of the securities affiliate are not sufficient.

4. Additional investments in a securities affiliate

If a bank holding company has acquired control of a securities affiliate under subparagraph (B) and later wishes to make an additional equity investment in the securities affiliate, the proposed acquisition is governed by subparagraph (D)(ii) (described below) rather than subparagraph (B).

C. Concentration of Resources

1. In general

Subparagraph (C)(i) requires the Federal Reserve Board to disapprove any acquisition under section 4(c)(15) of the Bank Holding Company Act that would result in an affiliation between a bank holding company or bank with total assets of more than \$30 billion, and an investment banking organization with total assets of more than \$15 billion. The assets of at least one of the two parties to the acquisition must be below the applicable dollar limitation both (1) on average during each of the eight calendar quarters preceding the date of application, and (2) at the time of the acquisition. If the

foregoing test is met, asset growth occurring after the acquisition has been lawfully consummated is irrelevant, and does not require any divestiture.

Subparagraph (C)(i) applies only to acquisitions under section 4(c)(15). Thus, for example, subparagraph (C)(i) does not apply to acquisitions under section 4(c)(13), which permits a bank holding company to acquire shares of a company that "does no business in the United States except as an incident to its international or foreign business." 12 U.S.C. § 1843(c)(13).

An acquisition results in an "affiliation" for purposes of subparagraph (C)(i) if it causes the parties to become "affiliates" within the meaning of section 2(k) of the Bank Holding Company Act. 12 U.S.C. § 1841(k).

Under subparagraph (C)(ii), the \$30 billion and \$15 billion limitations are to be adjusted annually after December 31, 1988, for inflation occurring after that date. The adjustment is to be made in the same manner as under the insurance restrictions of section 4(c)(8) (currently section 4(c)(8)(B), which section 203 of the bill redesignates as section 4(c)(8)(C)(ii)).

2. Acquisitions by foreign investment banking organizations and foreign banks

Subparagraph (C) applies to the acquisition of a U.S. bank holding company or bank by a foreign investment banking organization, for such an acquisition would require the foreign investment banking organization to become a bank holding company and conform its activities to section 4 of the Banking Holding Company Act. In connection with its application to become a bank holding company, the foreign investment banking organization would be required to file an application or notice under section 4(c)(15) to retain its securities business in the United States or under section 4(c)(13) to retain its securities business abroad. Subparagraph (C) would require the Board to disapprove the 4(c)(15) application or notice if the foreign investment banking organization's total assets were more than \$15 billion and the bank holding company's total assets were more than \$30 billion.

Subparagraph (C) also applies to acquisitions by foreign banks and their parent companies. Under section 8(a) of International Banking Act of 1978, the nonbanking activities in the United States of any foreign bank or foreign company that controls a foreign bank are generally subject to section 4 of the Bank Holding Company Act "in the same manner and to the same extent as bank holding companies are subject thereto," so long as the foreign bank or parent company has a commercial banking presence in the United States. 12 U.S.C. § 3106(a). A foreign bank is covered if it has a branch or agency in any State or the District of Columbia, or if it controls a commercial lending company organized under State or D.C. law; a company that controls such a foreign bank or such a commercial lending company is also covered. Thus "bank holding company or bank," as used in subparagraph (C), includes any such foreign bank or parent company.

Such a foreign bank or parent company cannot evade section 4(c)(15) by using grandfather rights under section 8(c) of the International Banking Act or the special investment authority conferred

by section 2(h)(2) of the Bank Holding Company Act. Section 8(c) does not permit a foreign bank or parent company to expand its grandfather rights by acquiring a going concern. Section 2(h)(2) cannot be used to engage in, or acquire more than 5 percent of the voting shares of a company engaged in, any securities activity. 12 U.S.C. § 1841(h)(3).

There are two narrow classes of acquisitions to which subparagraph (C) would not literally apply, as the acquisition would not be subject to disapproval under section 4(c)(15) of the Bank Holding Company Act:

(1) the acquisition of an investment banking organization by a foreign bank or parent company, if at the time of acquisition neither the investment banking organization nor the foreign bank or parent company had any commercial banking presence in the United States; and

(2) the acquisition of a bank holding company or bank by a foreign investment banking organization, if at the time of acquisition neither the bank holding company or bank nor the foreign investment banking organization conducted investment banking activities in the United States.

Under certain circumstances, however, such acquisitions would be covered by section 109 of the bill, which is intended to prevent the evasion of section 4(c)(15)(C).

D. Investment in a Securities Affiliate

1. Initial acquisition

A bank holding company may not acquire control of a securities affiliate under section 4(c)(15) if the acquisition would reduce the bank holding company's capital below the minimum level established by the Board for bank holding companies. The Federal Reserve Board must disapprove any application or notice involving such an acquisition. (As discussed below, subparagraph (E)(i) provides that a bank holding company's capital contributions to a securities affiliate be subtracted from the bank holding company's own capital for purposes of regulatory capital requirements.)

2. Additional equity investments

Once a bank holding company has acquired control of a securities affiliate under section 4(c)(15), the bank holding company must give the Board prior written notice under subparagraph (D)(ii) of any proposed additional equity investment in the securities affiliate, including an investment in the form of preferred stock, nonvoting common stock, or convertible debt, or in the form of subordinated debt that is considered capital for purposes of any capital requirement imposed on the securities affiliate by the SEC. The investment may not be made until the earlier of the following: (1) the Board issues a written statement of its intent not to disapprove the notice; or (2) 30 days elapse after the notice is filed, without the Board disapproving the notice.

The Board may disapprove a notice filed under subparagraph (D)(ii) if it finds that the proposed investment (1) would reduce the bank holding company's capital below the minimum level established by the Board for bank holding companies, or (2) would other-

wise be unsafe or unsound or inconsistent with the bank holding company's obligation to serve as a source of strength to its subsidiary banks.

E. Capital Standards for Bank Holding Companies

1. In general

Subparagraph (E)(i), in conjunction with subparagraph (D), adjusts the capital standards for bank holding companies and their securities affiliates for two important purposes: to promote the safety and soundness of the bank holding company; and to promote functional regulation of the securities affiliate as well as competitive equity between the securities affiliate and securities firms unaffiliated with banks.

Subparagraph (E)(i) promotes safety and soundness in two ways. First, it requires a bank holding company to establish a capital cushion in order to invest in and maintain a securities affiliate. Specifically, a bank holding company may invest in a securities affiliate only with capital over and above the capital necessary to satisfy minimum bank holding company capital requirements. As a result, if the securities affiliate were to fail, the bank holding company's loss of its capital investment in the securities affiliate would not impair its ability to satisfy minimum capital requirements.

Second, the provision curtails a bank holding company's ability to engage in "double leveraging" to avoid its minimum bank holding company capital requirements. That is, a bank holding company would be required to establish a capital cushion if it borrowed money, used the proceeds to purchase stock in its securities affiliate, and then directed the securities affiliate to use the capital to support its own borrowing.

The provision promotes functional regulation and competitive equity by ensuring that the securities affiliate is subject to the same SEC-mandated capital standards as securities firms unaffiliated with banks, but is not itself subject to additional capital standards imposed by the Federal Reserve Board on bank holding companies.

The SEC imposes stringent capital requirements on brokers and dealers pursuant to section 15(c)(3) of the Securities Exchange Act. 15 U.S.C. § 78o(c)(3); 17 C.F.R. § 240.15c3-1. These requirements are fundamentally different from bank holding company capital standards because they are intended to deal with the risks inherent in securities activities, rather than the risks inherent in banking. Accordingly, it is appropriate that a securities affiliate be governed by SEC capital requirements, rather than bank holding company capital standards.

2. Excess capital requirement

Subparagraph (E)(i)(I) requires that, for regulatory capital purposes, a bank holding company's capital and total assets must each be reduced by an amount equal to the sum of (1) its equity investment in a securities affiliate, and (2) its extensions of credit that are considered capital of the securities affiliate pursuant to section 15(c)(3) of the Securities Exchange Act. Thus, each dollar contribut-

ed by a bank holding company to a securities affiliate's capital will result in a one-dollar reduction in the holding company's capital.

This requirement, in conjunction with the requirement of subparagraph (D)(i) that the acquisition of a securities affiliate may not reduce a bank holding company's capital below its minimum capital requirement, produces the following result: a bank holding company may acquire a securities affiliate only with capital exceeding the amount necessary to satisfy its minimum capital requirement. Put another way, a bank holding company at or below its minimum capital requirement could not acquire a securities affiliate unless it raised additional capital to cover the investment.

This provision also prevents double leveraging, as described above.

3. Securities affiliate's external funding

Under subparagraph (E)(i)(II), the assets and liabilities of the securities affiliate are not consolidated with those of the bank holding company for purposes of calculating the regulatory capital of the bank holding company. Thus, if the securities affiliate raises funds from sources other than the bank holding company, whether through debt or equity, the bank holding company would not be required to increase its holding company capital to support the new assets, as it would be required to do for assets that are consolidated. The securities affiliate itself would, of course, be required to increase *its* capital to support the new assets to the extent required by the SEC.

The effect of this provision is to apply the same SEC capital requirements to external funding by a securities affiliate as to external funding by a securities firm unaffiliated with a bank, but not to apply an additional layer of bank holding company capital requirements.

4. Securities affiliate's internal funding

Subparagraph (E)(i)(III) requires that, for regulatory capital purposes, a bank holding company's total assets and total liabilities *each* be reduced by the amount of any extensions of credit made by the holding company to its securities affiliate (unless the credit extensions are considered capital of the securities affiliate for purposes of the SEC's regulations, in which case subparagraph (E)(i)(I) applies instead). This provision, like subparagraph (E)(i)(II), means that the bank holding company would not be required to increase its holding company capital to support the new asset—the loan to its securities affiliate—as it is required to do for other loans. Again, however, the securities affiliate itself would be required to increase *its* capital to support the new asset received to the extent required by the SEC.

The result is similar to the result under subparagraph (E)(i)(I): internal funding of a securities affiliate through loans from its parent bank holding company is subject only to SEC capital requirements, not bank holding company capital requirements as well. This put such internal funding by a securities affiliate on the same footing as similar internal funding by a securities subsidiary of a holding company unaffiliated with a bank.

The Committee intends that the Board not use parent-only capital standards to frustrate the intent of subparagraph (E)(i).

5. Nonsecurities activities of a securities affiliate

Section 4(c)(15)(A)(iii) permits a securities affiliate to engage in any nonbanking activity permissible for a bank holding company (e.g., mortgage banking). However, the adjustments made by subparagraph (E)(i) in bank holding companies' capital adequacy calculations and intended to apply only to the *securities* activities of securities affiliates. The Committee does not intend to exempt a bank holding company's nonsecurities activities from normal capital requirements merely because they are conducted through a securities affiliate; such an exemption would create an artificial incentive to transfer those activities into the securities affiliate. Accordingly, subparagraph (E)(ii) provides that the adjustments prescribed by subparagraph (E)(i) shall not be made to the extent that the Federal Reserve Board determines by order that the accounting items in question relate to nonsecurities activities.

Any order under subparagraph (E)(ii) is subject to judicial review under section 9 of the Bank Holding Company Act. 12 U.S.C. § 1848.

F. Limitations on Securities Affiliates and Their Affiliates

Subparagraph (F) imposes a series of restrictions on securities affiliates, on banks and thrift institutions that are affiliated with securities affiliates, and on subsidiaries of those banks or thrifts. A bank or thrift is affiliated with a securities affiliate if it is controlled by the same bank holding company.

1. No extension of credit or purchase of financial assets by affiliated banks.

Subparagraph (F)(i) prohibits any bank or thrift affiliated with a securities affiliate from directly or indirectly:

- (1) extending credit in any manner to the securities affiliate or any subsidiary of the securities affiliate;
- (2) purchasing for its own account financial assets of the securities affiliate or any subsidiary of the securities affiliate;
- (3) issuing a guarantee, acceptance, or letter of credit (including an endorsement or a standby letter of credit) for the benefit of the securities affiliate or any subsidiary of the securities affiliate; or
- (4) extending credit in any manner to any investment company (A) for which the securities affiliate acts as investment adviser or (B) whose shares are distributed by the securities affiliate.

The "directly or indirectly" language in subparagraph (F)(i), like that in other provisions of subparagraph (F), means that a bank or thrift may not do indirectly what it is prohibited from doing directly. Thus, for example, a bank may not loan money to a 4(c)(8) subsidiary of its parent bank holding company with the understanding that the money will be transferred to the securities affiliate. Nor may the bank do through one of its own subsidiaries what it is prohibited from doing directly.

2. Intraday exception for clearing U.S. Government or agency securities

Subparagraph (F)(ii) provides a narrow exception to the prohibition against extensions of credit to a securities affiliate. The exception is intended to facilitate the clearing of securities issued by the United States Government or its agencies, and securities on which the principal and interest are fully guaranteed by the United States Government or its agencies. A bank or thrift may extend credit to its securities affiliate in order to acquire or sell those securities if the extension of credit:

- (1) is to be repaid on the same calendar day;
- (2) is incidental to the clearing of transactions in those securities through that bank or thrift; and
- (3) is fully secured by such securities.

Banks regularly clear transactions (that is, administer transfers and payments) involving a full range of government and other securities for securities firms, including affiliated securities firms. Clearing securities transactions in the ordinary course of business necessarily involves extensions of credit by clearing banks to the securities firms involved. During any trading day, for example, the clearing bank pays for securities bought by the securities firm and the amount paid out may at any given time exceed the amount received by the bank for securities sold, resulting in an overdraft in the securities firm's clearing account at the bank. These temporary overdrafts are secured by the securities being cleared. *See, e.g.*, 31 C.F.R. § 306.118 (rules for pledging Treasury book-entry securities).

The exception created by subparagraph (F)(ii) permits a bank to continue to make such extensions of credit to its securities affiliate in the course of clearing the securities affiliate's transactions in the U.S. Government or agency securities in question. In view of the nature of the clearing process, the high quality of the securities involved, the requirement that any extension of credit be fully secured by such securities, and the short duration of any extension of credit, the exception does not implicate any of the policies underlying the general prohibition.

An extension of credit "is to be repaid" on the same calendar day if (1) the terms of the extension of credit obligate the borrower to repay it on that day, and (2) the lender, when making the extension of credit, reasonably believes that the extension of credit will in fact be repaid on that day. Thus routine "fails" do not violate the requirement that the extension of credit "is to be repaid" on the same calendar day. A fail occurs when a seller of securities does not promptly and properly deliver those securities, or when a buyer of securities does not promptly pay for them.

3. No enhancing marketability of securities underwritten by securities affiliate

Subparagraph (F)(iii) prohibits a bank or thrift institution affiliated with a securities affiliate from directly or indirectly extending credit—or issuing or entering into a standby letter of credit, asset purchase agreement, indemnity, guarantee, insurance, or other facility—for the purpose of enhancing the marketability of securities

that are being underwritten or distributed by the securities affiliate.

4. No extension of credit to purchase securities being underwritten by securities affiliate

Subparagraph (F)(iv) prohibits any bank holding company or any subsidiary of a bank holding company, other than a securities affiliate, from knowingly extending or arranging for the extension of credit that is secured by or for the purpose of purchasing any security (1) while that security is the subject of a distribution in which a securities affiliate of the bank holding company participates as a underwriter or a member of a selling group, or (2) for 30 days after that security ceases to be the subject of such a distribution. The prohibition applies by its terms to any subsidiary of a securities affiliate. Thus an extension of credit covered by subparagraph (F)(iv) may be made only by a securities affiliate itself, subject to the investor-protection and margin regulations applicable to brokers or dealers generally.

5. No extension of credit to pay principal or interest on securities underwritten by securities affiliate

Subparagraph (F)(v) prohibits a bank or thrift institution affiliated with a securities affiliate from directly or indirectly extending credit to an issuer of securities underwritten by the securities affiliate for the purpose of paying principal, interest, or dividends on those securities.

Subparagraph (F)(v) also contains a safe-harbor provision, under which a bank may extend credit for a documented purpose (other than paying principal, interest, or dividends) if the timing, maturity, and other terms of the credit, taken as a whole, are substantially different from those of any securities underwritten for that issuer by the securities affiliate. For purposes of this provision, "timing" means the timing of the extension of credit in relation to the timing of principal, interest, or dividend payments on the securities. "Other terms" include conditions.

In general, subparagraph (F)(v) is not intended to prohibit the refinancing of an existing loan. Unless the circumstances suggest otherwise, such a refinancing should be presumed to be for the same purpose as the original loan, and not for the purpose of paying principal, interest, or dividends on securities. Similarly, a general line of credit should not, in and of itself, be presumed to be for the purpose of paying principal, interest, or dividends on securities.

6. Restriction on officer and director interlocks

(a) *General rule.*—Subparagraph (F)(vi)(I) prohibits an officer or director of a securities affiliate from serving simultaneously as an officer or director of any affiliated bank or thrift institution.

As used in subparagraph (F)(vi), "officer" means a person with an official title (e.g., president) who participates or has authority to participate (other than as a director) in major policymaking functions of the bank, thrift, or securities affiliate, as the case may be. The term does not include persons who may exercise a certain measure of discretion in performing their duties, but who do not participate in determining major policies of the entity in question

and whose decisions are limited by policy standards fixed by the entity's senior management. Thus, for example, the term does not include a manager or assistant manager of a bank branch unless that person participates, or is authorized to participate, in major policymaking functions of the bank.

(b) *Exemption for bank holding companies with banking assets of \$500 million or less.*—Subparagraph (F)(vi)(II) exempts from the general prohibition of subparagraph (F)(vi)(I) bank holding companies that have total banking assets of \$500 million or less. Thus such a bank holding company may have an officer or director of one of its subsidiary banks or thrift institutions serve as an officer or director of the bank holding company's securities affiliate.

Under subparagraph (F)(vi)(III), the \$500 million limit on banking assets is to be adjusted annually after December 31, 1988, for inflation occurring after that date. The adjustment is to be made in the same manner as under the insurance restrictions of section 4(c)(8).

(c) *Board's authority to grant exemptions.*—Subparagraph (F)(vi)(IV) gives the Federal Reserve Board broad authority to grant exemptions from the general prohibition against officer or director interlocks. The Board may grant such exemptions by order in particular cases or by regulation. In determining whether to grant exemptions, the Board must consider (1) the size of the bank holding companies, banks, and securities affiliates involved, (2) any burdens that may be imposed by the prohibition against interlocks, (3) the safety and soundness of the banks and securities affiliates, and (4) other appropriate factors, including any potential for unfair competition or improper exchange of nonpublic customer information.

The Committee expects the Board to grant exemptions, especially for small and regional bank holding companies, when the services of key personnel are crucial to both the securities affiliate and the bank. A large bank holding company may have the resources to find and hire separate competent staffs to manage its bank and securities affiliate, but that may be much more difficult for a smaller bank holding company, particularly during the securities affiliate's start-up phase. For example, a bank officer who manages the bank's U.S. Government securities activities may be viewed as vital to the management of certain new securities activities in a securities affiliate, and as a practical matter it may be impossible to carry out either position without being an officer.

7. Disclosures by securities affiliate

Pursuant to regulations issued by the SEC, a securities affiliate shall make certain written disclosures emphasizing that the securities affiliate is separate from any affiliated bank or thrift, and that securities handled or recommended by the securities affiliate are not insured deposits. The Commission may prescribe the frequency and manner, including the specific language, of the disclosures. Any language prescribed by the Commission should be easily understandable to securities affiliates' customers. The Commission need not prescribe identical disclosures for all purposes. It could, for example, require that all points specified in subparagraph (F)(vii) be covered when an account is opened, and that shorter disclosures be made periodically thereafter.

8. Investment advice by affiliated bank or thrift

If a bank holding company has a securities affiliate, subparagraph (F) (viii) limits certain investment advice by the bank holding company's subsidiary banks and thrift institutions and by any subsidiary of such a bank or thrift. The bank, thrift, or subsidiary may not express any opinion on the value of securities that are being underwritten, distributed, or dealt in by the securities affiliate—or on the advisability of purchasing or selling such securities—without informing the customer that the securities affiliate is underwriting, distributing, or dealing in the securities.

9. No disclosure of confidential customer information without customer's consent

Subparagraph (F)(ix) prohibits the disclosure of nonpublic information about a customer, without the customer's consent:

(1) *by a bank or thrift institution or any subsidiary of a bank or thrift to an affiliated securities affiliate; or*

(2) *by a securities affiliate to an affiliated bank or thrift institution or any subsidiary of an affiliated bank or thrift.*

Subparagraph (F)(ix) does not prohibit disclosure pursuant to the customer's consent. Thus, for example, if the customer requests the bank to disclose the customer's credit history to the securities affiliate in connection with the underwriting of securities to be issued by the customer, subparagraph (F)(ix) does not prohibit the bank from complying with the request. Such a prohibition could impose needless costs and inconvenience on the customer (e.g., by forcing the securities affiliate or the customer to attempt to replicate from outside sources information already possessed by the bank); reduce the quality of credit information available to banks and securities affiliates; make it difficult for a bank holding company to meet a customer's needs for both banking and securities services; and disadvantage any customer that seeks to obtain those services from an affiliated bank and securities affiliate (e.g., by prohibiting the disclosure of credit information that may be unavailable from outside sources).

Subparagraph (F)(ix) does *not* affect other laws governing the use of material nonpublic information, such as the prohibitions against insider trading. Thus, for example, although subparagraph (F)(ix) does not prohibit nonpublic customer information from being disclosed with the customer's consent, it in no way legitimizes an otherwise impermissible use of that information to purchase or sell a security.

10. Rating requirement for asset—related securities involving loans originated by an affiliated bank or thrift

Subparagraph (F)(x) prohibits a securities affiliate from underwriting or distributing securities that are secured by, or represent an interest in, mortgages or other obligations originated by an affiliated bank, thrift institution, or subsidiary thereof unless those securities ("asset-related securities"):

(1) *are rated by an unaffiliated, nationally recognized statistical rating organization; or*

(2) are issued or guaranteed by the Federal Home Loan Mortgage Corporation, the Federal National Mortgage Association, or the Government National Mortgage Association, or represent interests in securities issued or guaranteed by those agencies.

The rating requirement ensures that the investing public will have the benefit of an impartial third party's expert evaluation of any such securities that are being underwritten or distributed by the securities affiliate.

The rating requirement is not applied to securities issued or guaranteed by one of the three Government-sponsored home-mortgage financing agencies. Each agency has standards for mortgages underlying any asset-related securities that it issues or guarantees. Moreover, the agency itself is responsible for paying the principal of and interest on the securities, regardless of how the mortgages perform. The agency's mortgage evaluation standards and direct responsibility give investors protection that is at least equivalent to that of a rating.

Subparagraph (F)(x) does not prohibit a securities affiliate from dealing in unrated asset-related securities. Dealing involves no public offering of securities; it involves trading in securities that are already in the hands of investors, and for which there is a secondary market. As the process of distribution is complete in the case of those securities, and as those securities have a market price, the rating requirement is unnecessary.

11. Regulatory agencies' programs to enforce compliance and respond to complaints

Subparagraph (F)(xi) requires each of the three Federal banking agencies to establish a program (1) for ensuring that the banks it supervises comply with section 4(c)(15), and (2) for responding to any complaints from customers about inappropriate cross-marketing of securities products or inadequate disclosure. Parallel programs must be established by the SEC for securities affiliates, and by the Federal Home Loan Bank Board for FSLIC-insured thrifts controlled by bank holding companies.

These programs are intended as an additional safeguard against possible abuse—a speedy and inexpensive supplement to the regulatory, judicial, and other remedies already available to customers.

12. Effect of section 4(c)(15) on other laws

Subparagraph (F)(xii) affirms that section 4(c)(15) does not preempt other banking or securities regulation. Subparagraph (F)(xii)(I) provides that section 4(c)(15) does not limit the authority of Comptroller of the Currency, the FDIC, the Federal Home Loan Bank Board, the FSLIC, or the SEC. Subparagraph (F)(xii)(II) provides that section 4(c)(15) does not limit any disclosure or registration requirements under the Federal securities laws.

There is no need to mention State regulatory agencies or State securities laws in subparagraph (F)(xii). Section 7 of the Bank Holding Company Act provides that the Act does not restrict the States' authority over companies, banks, bank holding companies, and subsidiaries of those entities. 12 U.S.C. § 1846. Thus section 4(c)(15),

which is subject to section 7, does *not* preempt State securities laws or the authority of State regulatory agencies (except to the narrow extent provided in section 105 of the bill).

Subparagraph (F)(xii)(I) does not permit the Federal agencies listed there to vary or abridge any provision of section 4(c)(15).

G. Securities Affiliates Approved Under Section 4(c)(8)

Subparagraph (G) is intended to prevent section 4(c)(8) from being used to circumvent section 4(c)(15).

1. "Engaged principally" applications previously approved

Acting under section 4(c)(8), the Federal Reserve Board has already authorized bank holding companies to engage through non-bank subsidiaries in underwriting, distributing, and dealing in commercial paper, municipal revenue bonds, and mortgage/backed securities. The United States Court of Appeals for the Second Circuit has upheld the Board's action, holding that the activities in question do not violate the "engaged principally" standard of section 20 of the Glass-Steagall Act if they account for only a small proportion of the subsidiary's total business. *Securities Industry Association v. Board of Governors*, 839 F.2d 47 (2d Cir. 1988).

Subparagraph (G)(i) extends section 4(c)(15) to any 4(c)(8) subsidiary engaged in underwriting, distributing, or dealing in securities. It does so by prohibiting a bank holding company from engaging in, or retaining the shares of a company engaged in, those activities on the basis of the Board's approval of an application under section 4(c)(8) unless the bank holding company receives the Board's approval to retain those shares pursuant to section 4(c)(15), or except to the extent that the underwriting, distribution, or dealing satisfies *both* parts of the following test:

- (1) national banks must be *specifically authorized by statute* to engage in the underwriting, distribution, or dealing; and
- (2) the underwriting, distribution, or dealing must involve securities that are *expressly described* in at least one of two ways:
 - (A) expressly described in the statute that specifically authorizes national banks to engage in that activity; or
 - (B) expressly described in a regulation promulgated by the Comptroller of the Currency pursuant to that statute before November 18, 1987, as being authorized for a national bank to underwrite or deal in.

If an activity is impermissible for a national bank, it cannot possibly be "specifically authorized by statute," and thus cannot be conducted by a 4(c)(8) subsidiary, regardless of whether the activity involves securities that are expressly described in the Comptroller's regulations.

The foregoing two-part test is intended to ensure that the Comptroller cannot broaden the scope of the underwriting, distribution, and dealing activities that can be conducted without approval under section 4(c)(15); it does not represent a judgment about what activities are or are not permissible for a national bank. The test does not prevent the Comptroller from issuing interpretations seeking to clarify what securities are eligible for national banks to underwrite and deal in. See analogous discussion in Senate Report No. 368, 96th Cong., 1st Sess. 249 (1979), which stated that the

Comptroller "shall not use . . . rulemaking authority, as opposed to interpretive rulings which are requested from time to time, to decide issues related to the Glass-Steagall Act."

2. Future notices

Subparagraph (G)(ii) requires the Board to disapprove any notice filed under section 4(c)(8) to underwrite, distribute, or deal in securities or to acquire the shares of a company engaged in any such activity. There is an exception for activities that meet the "specifically authorized" and "expressly described" test of subparagraph (G)(i)(II).

H. Securities Activities of Affiliated Banks

Subparagraph (H) limits securities underwriting, distribution, and dealing by banks that are affiliated with a securities affiliate. A bank holding company must, within one year after acquiring a securities affiliate have its subsidiary banks transfer to the securities affiliate (or else cease to engage in) the following activities:

- (1) underwriting, distributing, and dealing in securities, except to the extent that those activities meet the "specifically authorized" and "expressly described" test of subparagraph (G)(i)(II); and
- (2) underwriting or distributing securities backed by or representing an interest in mortgages or other obligations originated or purchased by the bank or its affiliates.

The latter requirement ensures that a bank affiliated with a securities affiliate may not underwrite or distribute its own securitized assets, even if the activities in question meet the two-part test of subparagraph (G)(i)(II).

I. Compliance with Risk-Based Capital Standards

Under subparagraph (I)(i), a securities affiliate may not begin to underwrite, distribute, or deal in certain corporate debt securities or equity securities unless each of the securities affiliate's banks is in compliance with any applicable risk-based capital standards issued by that bank's appropriate Federal banking agency (as defined in subparagraph (J)(iii) and discussed below in connection with that subparagraph). The securities in question are:

- (1) unsecured corporate debt securities that at the time of issuance have a maturity of one year or more; and
- (2) equity securities other than those issued by a registered investment company.

For purposes of subparagraph (I)(i), neither "unsecured corporate debt securities" nor "equity securities" includes: (1) asset-related securities (e.g., collateralized mortgage obligations or mortgage-related pass-through certificates); (2) securities of a U.S. Government agency or international agency that national banks are authorized by statute (e.g., section 16 of the Glass-Steagall Act) to underwrite, distribute, or deal in—even if that agency (e.g., the Federal National Mortgage Association or the World Bank) is organized as a corporation; or (3) securities of a corporation that is an instrumentality of any State, territory, or possession of the United States, any political subdivision thereof, the District of Columbia, or any

agency of any of the foregoing, if national banks are authorized by statute to underwrite, distribute, or deal in those securities.

If the appropriate Federal banking agency prescribes a schedule for the bank to achieve full compliance with risk-based capital standards, the bank is in compliance with those standards for purposes of subparagraph (I)(i) if (1) the bank's capital is at or above the level then required under the schedule, and (2) it appears that the bank can continue to meet the schedule.

J. Definitions

1. Foreign bank branch, agency, and commercial lending company

Subparagraph (J)(i) provides that a branch or agency of a foreign bank, or a commercial lending company controlled by a foreign bank, shall be considered a bank for purposes of section 4(c)(15). Thus, if a foreign bank has a securities affiliate, transactions between the securities affiliate and the foreign bank's branches, agencies, and commercial lending companies are subject to the same restrictions under section 4(c)(15) as transactions between a securities affiliate and an affiliated bank.

2. Bankers' banks and bankers' bank holding companies

A bankers' bank is a bank that is owned by other depository institutions, directly or through a bankers' bank holding company, and is organized to engage exclusively in providing services to other depository institutions. *See, e.g.,* 12 U.S.C. § 27(b)(1). A bankers' bank holding company is a company that controls a bankers' bank and is itself controlled by depository institutions. The shares of a bankers' bank holding company are usually owned by more than 20 depository institutions, none of which owns more than 5 percent of any class of voting securities. *See, e.g.,* 12 U.S.C. § 24 (Seventh). As those depository institutions do not individually control the bankers' bank holding company, it could be argued that they would not be affiliates of any securities affiliate of the bankers' bank holding company, and thus would not be subject to the restrictions imposed by section 4(c)(15) (e.g., the prohibition against extending credit to the securities affiliate).

Subparagraph (J)(ii) provides that if a bankers' bank holding company has a securities affiliate, then each shareholder or participant in the bankers bank holding company—and each subsidiary of such a shareholder or participant—shall, for purposes of section 4(c)(15), be treated as if it were a subsidiary of the bankers' bank holding company. This ensures that such entities are fully subject to the provisions of section 4(c)(15) regarding banks or thrifts affiliated with securities affiliates or subsidiaries of those banks or thrifts. Thus, for example, section 4(c)(15)(F)(i) prohibits a bank that is a shareholder of a banker's bank holding company from extending credit to any securities affiliate of the bankers' bank holding company.

"Shareholder" includes a holder of common stock, whether voting or nonvoting; preferred stock; or convertible debt.

"Participant" refers to a depository institution that, although not holding shares of the bankers' bank holding company, has an inter-

est in the company's success similar to that of a shareholder (e.g., through a joint venture).

A director of a banker's bank holding company is not a "shareholder" of the company for purposes of subparagraph (J)(ii) solely because of holding shares that he or she is required to hold in order to qualify as a director.

3. "Appropriate Federal banking agency"

The definition of "appropriate Federal banking agency" in subparagraph (J)(iii) is largely incorporated from section 3(q) of the Federal Deposit Insurance Act. 12 U.S.C. § 1813(q). Thus the term refers to the Comptroller of the Currency in the case of national banks, the Federal Reserve Board in the case of State member banks, and the Federal Deposit Insurance Corporation ("FDIC") in the case of State nonmember banks. In addition, subparagraph (J)(iii) defines the term so as to include the Federal Home Loan Bank Board in the case of savings and loan associations insured by the Federal Savings and Loan Insurance Corporation ("FSLIC").

4. "Dealing"

The common understanding of "dealing" is reflected in the Securities Exchange Act's definition of "dealer" as a person "engaged in the business of buying and selling securities for his own account." 15 U.S.C. § 78c(a)(5). A "broker," by contrast, is "engaged in the business of effecting transactions in securities for the account of others." *Id.* 78c(a)(4). Section 16 of the Glass-Steagall Act appears to confuse the issue by providing that a national bank's "business of dealing in securities . . . shall be limited to purchasing and selling such securities . . . without recourse, solely upon the order, and for the account of customers." 12 U.S.C. § 24 (Seventh) (emphasis added).

To make it clear that "dealing" does not encompass brokerage (or other transactions in which one acts solely as agent of one's customer), subparagraph (J)(iv) specifies that "dealing" and "dealing in" do not include purchasing or selling securities for the account of another person.

5. Insurance

Subparagraph (J)(v) restricts the meaning of "securities" and "securities activities" in section 4(c)(15). "Securities" does not include "insurance," as defined in section 4(j)(4)(A) of the Bank Holding Company Act (added by section 802(b) of the bill). "Securities activities" does not include "insurance activities," as defined in section 2(o) of the Act (section 802(a) of the bill). These restrictions are consistent with section 4(j)(1) of the Act, which restricts the insurance activities of bank holding companies and their subsidiaries and affiliates.

K. Phase-in or Separate Congressional Vote on Certain Securities Activities

Under subparagraph (K), a securities affiliates may not underwrite, distribute, or deal in the following securities until 180 days after the bill becomes law:

(1) unsecured corporate debt securities that at the time of issuance have a maturity of one year or more; and

(2) securities issued by a registered investment company.

Moreover, a securities affiliate may not underwrite, distribute, or deal in equity securities (other than those issued by a registered investment company) except pursuant to a joint resolution under section 113 of the bill.

For purposes of subparagraph (K), neither "unsecured corporate debt securities" nor "equity securities" includes: (1) asset-related securities (e.g., collateralized mortgage obligations or mortgage-related pass-through certificates); (2) securities of a U.S. Government agency or international agency that national banks are authorized by statute (e.g., section 16 of the Glass-Steagall Act) to underwrite, distribute, or deal in—even if that agency (e.g., the Federal National Mortgage Association or the World Bank) is organized as a corporation; or (3) securities of a corporation that is an instrumentality of any State, territory, or possession of the United States, any political subdivision thereof, the District of Columbia, or any agency of any of the foregoing, if national banks are authorized by statute to underwrite, distribute, or deal in those securities.

Shares issued by a registered investment company are covered by subparagraph (K)(i)(II) (180-day phase-in) rather than subparagraph (K)(ii) (joint resolution), even if the investment company itself invests in equity securities.

SECTION 103. DEFINITION OF SECURITIES AFFILIATE

This section adds a definition of "securities affiliate" to the Bank Holding Company Act. A company is a securities affiliate if it meets a two-part test: First, it must engage in the United States pursuant to section 4(c)(15)(A) in activities permissible under that section. Second, it must be registered with the SEC as a broker or dealer. In accordance with this definition, a company is a securities affiliate only so long as it is owned or controlled by a bank holding company; if it is not so owned or controlled, it will not be operating "pursuant to section 4(c)(15)(A)."

Once a company has been authorized to operate under section 4(c)(15), it remains a securities affiliate as long as it conducts any securities or nonsecurities activity permissible under section 4(c)(15)(A). The company cannot avoid the restrictions of section 4(c)(15) by voluntarily confining its activities to those permissible under section 4(c)(8); to be free from those restrictions, it must terminate its authority under section 4(c)(15). (If the Federal Reserve Board does not prescribe a procedure for terminating that authority, written notice to the Board or its designee will suffice.) Thus the Board can readily ascertain whether a given subsidiary of a bank holding company is a securities affiliate.

SECTION 104. NINETY-ONE DAY RULE FOR SECURITIES AFFILIATE APPLICATIONS

Section 4(c) of the Bank Holding Company Act currently provides that an application under section 4(c)(8) is automatically approved if the Federal Reserve Board fails to act on the application within

91 days after the complete record on the application is submitted to the Board. 12 U.S.C. § 1843(c).

This section amends section 4(c) so as to make the 91-day rule applicable to applications to acquire shares of a securities affiliate filed under section 4(c)(15)(B), and inapplicable to applications under section 4(c)(8). The latter change is included because section 203 of the bill replaces the current application procedure under section 4(c)(8) with a 60-day notice procedure.

Four years after the bill is enacted, the 91-day rule will be repealed altogether as part of the shift from an application procedure to a notice procedure under section 4(c)(15)(B).

SECTION 105. EFFECT ON STATE LAWS PROHIBITING THE AFFILIATION OF BANKS AND SECURITIES COMPANIES

Section 7 of the Bank Holding Company Act currently provides that the Act does not restrict the States' authority over companies, banks, bank holding companies, and subsidiaries of those entities. 12 U.S.C. § 1846. This section establishes a limited exception to that rule by providing that a State may not prohibit a bank or bank holding company from being affiliated with a securities affiliate (or a securities affiliate from being affiliated with a bank or bank holding company) solely because the securities affiliate is engaged in securities activities that are permissible under section 4(c)(15)(A)(i)-(ii).

SECTION 106. AMENDMENT TO THE FEDERAL RESERVE ACT

Section 23B(b)(1)(B) of the Federal Reserve Act prohibits a member bank or its subsidiaries from purchasing or otherwise acquiring any security "during the existence of any underwriting or selling syndicate" if any affiliate of the bank is a principal underwriter of that security. 12 U.S.C. § 371c-1(b)(1)(B).

This section makes the prohibition also applicable for 30 days after the syndicate terminates.

SECTION 107. SECURITIES AFFILIATIONS OF FDIC-INSURED BANKS

A. General Rule

Subparagraph (a) establishes the basic rule for FDIC-insured banks, whether member or nonmember: except as provided in section 4(c)(15) of the Bank Holding Company Act, an FDIC-insured bank may not be affiliated with any company that acts in the United States as an underwriter or dealer of any security other than certain eligible securities. This rule applies to all FDIC-insured banks except those specifically excluded in subparagraph (B), and to all affiliations except those grandfathered under subparagraph (D). As defined in subparagraph (F)(i), a bank's "affiliates" include any parent company, any subsidiary of the bank, and any company that is under common control with the bank.

Subparagraph (A) applies to a bank's affiliation with a company that acts as an "underwriter" or "dealer" of securities. Because "underwriter" is defined so broadly in subparagraph (F)(v), subparagraph (A) needs no separate reference to the "distribution" of securities.

Subparagraph (A) does not prohibit a bank from being affiliated with a company that restricts its underwriting and dealing to securities that satisfy *both* parts of the following test:

(1) national banks must be *specifically authorized by statute* to underwrite or deal in those securities; and

(2) the securities must be *expressly described* in at least one of two ways:

(A) expressly described in the statute that specifically authorizes national banks to underwrite or deal in those securities; or

(B) expressly described in a regulation promulgated by the Comptroller of the Currency pursuant to that statute before November 18, 1987, as being authorized for a national bank to underwrite or deal in.

If a national bank can neither underwrite nor deal in the securities, then the securities cannot possibly meet the "specifically authorized" part of the two-part test, and thus cannot be underwritten or dealt in by an affiliate under the general rule of subparagraph (A), regardless of whether the securities are expressly described in the Comptroller's regulations.

The two-part test is intended to ensure that the Comptroller cannot broaden the eligible class by administrative action. Cf. 12 U.S.C. § 93a (excluding from the Comptroller's general rulemaking authority the securities activities of national banks under the Glass-Steagall Act).

The two-part test is concerned solely with the activities of companies affiliated with banks; it does not represent a judgment about what activities are or are not permissible for a national bank. Nor does it prevent the Comptroller from issuing interpretations seeking to clarify what securities are eligible for national banks to underwrite and deal in. See analogous discussion in Senate Report No. 368, 96th Cong., 1st Sess. 249 (1979), which stated that the Comptroller "shall not use . . . rulemaking authority, as opposed to interpretive rulings which are requested from time to time, to decide issues related to the Glass-Steagall Act."

As used in subparagraph (A), "in the United States" is consistent with the Federal Reserve Board's existing regulations and interpretations on the incidental U.S. activities of Edge corporations. 12 C.F.R. pt. 211.

B. Exceptions

Under subparagraph (B)(i), the general prohibition of subparagraph (A) does not apply to affiliations between a securities underwriter or dealer and certain institutions that are excluded from the Bank Holding Company Act's definition of a "bank":

(1) trust-company banks that comply with section 2(c)(2)(D) of the Banks Holding Company Act;

(2) credit-card banks that comply with section 2(c)(2)(f) of that Act; and

(3) the institution covered by section 2(c)(2)(I) of that Act.

None of these institutions allowed to conduct a general banking business. On the contrary, their activities are so tightly constrained by the terms of their exemptions from the definition of a "bank" that an affiliation between such an institution and an underwriter

or dealer would be unlikely to raise the kind of issues with which sections 18(j)(3) and 4(c)(15) are concerned.

The general prohibition of subparagraph (A) also does not apply to affiliations between a securities underwriter or dealer and an industrial bank, industrial loan company, or similar institution that complies with section 2(c)(2)(H) of the Bank Holding Company Act, and thus is excluded from the Act's definition of a "bank".

Subparagraph (B)(ii) prevents the general prohibition of subparagraph (A) from extending to the *foreign* activities of a foreign bank. This provision, which is drawn from section 2(c)(2)(A) of the Bank Holding Company Act, is included because section 3(h) of the Bank Holding Company Act, is included because section 3(h) of the Federal Deposit Insurance Act treats a foreign bank that has a federally insured branch as an FDIC-insured bank for certain purposes. 12 U.S.C. § 1813(h). Subparagraph (B)(ii) does not expand foreign banks' powers within the United States.

Under section 18(j)(5) of the Federal Deposit Insurance Act, the general prohibition of subparagraph (A) does not apply to FDIC-insured Federal savings banks. 12 U.S.C. 1828(j)(5).

C. Grandfather Provision

Under subparagraph (C), an affiliation that existed on March 5, 1987, between an FDIC-insured bank and a company that acts as an underwriter or dealer may continue, even if it would otherwise violate subparagraph (A). Moreover, the affiliated underwriter or dealer may acquire the assets of another underwriter or dealer—or the other underwriter or dealer may be merged into the affiliated underwriter or dealer—so long as no new affiliation results.

This section is not intended to prohibit a company that was affiliated with an FDIC-insured bank on March 5, 1987, from continuing to establish or underwrite new mutual funds, limited partnerships, separate accounts, or other commingled investment vehicles in the ordinary course of its business, or from restructuring its existing activities.

D. Transition Rule

Under subparagraph (D), any affiliation not grandfathered under subparagraph (C) may continue until August 10, 1989, if it was lawfully commenced before the bill is enacted.

E. Activities Conducted Directly by Insured Bank

Subparagraph (E) affirms that nothing in section 18(j)(3) restricts any activity that is conducted directly by an insured bank and is subject to section 21 of the Glass-Steagall Act. Accordingly, section 18(j)(3) may not be construed as prohibiting one FDIC-insured bank from being affiliated with another such bank because of activities that are conducted directly by one or both of the banks and are permissible under section 21.

Subparagraph (E) does *not* exclude from the reach of section 18(j)(3) activities conducted in any subsidiary or other affiliate of a bank. Those activities are not "conducted directly" by the bank for purposes of subparagraph (E) and, under recent court decisions, are not subject to section 21 of the Glass-Steagall Act. *Investment Com-*

pany Institute v. Federal Deposit Insurance Corp., 815 F.2d 1540, 1546-49 (D.C. Cir.), *cert. denied*, 108 Sup. Ct. 143 (1987).

F. Definitions

To prevent evasion of section 4(c)(15), the definitions of key terms used in section 18(j)(3) are incorporated from broad and well-established definitions found in other statutes.

1. "Affiliate"

The definition of "affiliate" is incorporated from section 2(k) of the Bank Holding Company Act, where it is currently defined as "any company that controls, is controlled by, or is under common control with another company." 12 U.S.C. § 1841(k).

2. "Company"

The definition of "company" is incorporated from section 2(b) of the Bank Holding Company Act, where it is currently defined as "any corporation, partnership, business trust, association, or similar organization, or any other trust unless by its terms it must terminate within twenty-five years or not later than twenty-one years and ten months after the death of individuals living on the effective date of the trust." "Company" excludes corporations in which the Federal Government or any State owns a majority of the shares. 12 U.S.C. § 1841(b).

3. "Dealer"

The definition of "dealer" is incorporated from section 3(a)(5) of the Securities Exchange Act (as amended by section 302 of the bill), where it is defined as "any person engaged in the business of buying and selling securities for his own account." "Dealer" does not include (1) one who purchases and sells securities solely for the account of others, or (2) a bank under certain circumstances. (The exemption for banks does not, however, extend to any nonbank subsidiary or affiliate of a bank.)

4. "Security"

The definition of "security" is incorporated from section 3(a)(10) of the Securities Exchange Act. 15 U.S.C. § 78c(a)(10). However, the Federal Reserve Board is given limited exemptive authority *just in case* a traditional bank product (such as loan participations, mortgage notes, or certificates of deposit) were at some future time determined to be a "security" under section 3(a)(10). Specifically, the Board may by regulation exempt from the definition of "security" in section 18(j)(3)(F)(iv) banking products that have been traditionally and customarily originated or handled by national banks, if the exemption is consistent with the purpose of section 18(j)(3) and section 4(c)(15).

The reference to "loan participations, mortgage notes, and certificates of deposit" in section 18(j)(3)(F)(iv)(II) is simply intended to illustrate the types of instruments covered by the Board's exemptive authority. The reference is *not* intended to imply that those instruments are "securities" for purposes of section 3(a)(10), or to affect in any way judicial determinations that those instruments are not "securities" for purposes of section 3(a)(10). *See, e.g., Marine*

Bank v. Weaver, 455 U.S. 551, 557-59 (1982) (certificate of deposit issued by a federally regulated bank is not a "security"); *American Fletcher Mortgage Co. v. U.S. Steel Credit Corp.*, 635 F.2d 1247, 1253-55 (7th Cir. 1980) (notes evidencing mortgage loans, and participations in those notes, are not "securities"), *cert. denied*, 451 U.S. 911 (1981); *United American Bank of Nashville v. Gunter*, 620 F.2d 1108 (5th Cir. 1980) (rejecting reasoning of *Lehigh Valley Trust Co. v. Central National Bank of Jacksonville*, 409 F.2d 989 (5th Cir. 1969), and holding that a loan participation is not a "security").

5. "Underwriter"

The definition of "underwriter" is incorporated from section 2(11) of the Securities Act of 1933, where it is currently defined as "any person who has purchased from an issuer with a view to, or offers or sells for an issuer in connection with, the distribution of any security, or participates or has a direct or indirect participation in the direct or indirect underwriting of any such undertaking." However, "underwriter" does not include "a person whose interest is limited to a commission from an underwriter or dealer not in excess of the usual and customary distributors' or sellers' commission." 15 U.S.C. § 77(b)(11).

G. Conforming Amendment

Section 408(m)(1)(A)(i) of the National Housing Act permits the FSLIC to authorize any company to acquire a failing thrift institution "[n]otwithstanding any provision of . . . State . . . or Federal law, except as provided in . . . clause (iii) of this subparagraph." 12 U.S.C. § 1730a(m)(1)(A)(i). Under clause (iii), a bank holding company's acquisition of a thrift institution requires the approval of the Federal Reserve Board and is subject to the nonbanking activity restrictions of the Bank Holding Company Act.

Section 408(m)(1)(A) was enacted against the background of the Glass-Steagall Act and the Bank Holding Company Act. The Federal Reserve Board had determined that activities prohibited for bank affiliates by section 20 of the Glass-Steagall Act were not "so closely related to banking as to be a proper incident thereto" and thus were not permissible under section 4(c)(8) of the Bank Holding Company Act. 12 C.F.R. § 225.125(b). Because the bill overturns that fundamental rule by repealing section 20 of the Glass-Steagall Act, it is appropriate to amend section 408(m)(1)(A)(i) to avoid any implication that a bank holding company could use that section to circumvent the safeguards of sections 4(c)(15) and 18(j)(3).

H. Technical Amendment

Section 107(c) amends section 18(j)(4)(A) of the Federal Deposit Insurance Act so as to reflect changes made by other provisions of the bill. As added by the Competitive Equality Banking Act of 1987 and as in effect until March 1, 1988, section 18(j)(3)(A) of the Federal Deposit Insurance Act applied section 20 of the Glass-Steagall Act to State nonmember banks insured by the FDIC. Section 18(j)(4)(A) imposed a civil penalty of up to \$1,000 per day on any such bank that violated section 20. However, section 101 of the bill repeals section 20, and section 107(a) of the bill rewrites section

18(j)(3). Accordingly, section 107(c) amends section 18(j)(4)(A) by replacing the reference to section 20 with a reference to section 18(j)(3). The effect is to impose civil penalties of up to \$1,000 per day for violations of section 18(j)(3).

SECTION 108. AUTHORIZATION FOR NATIONAL BANKS TO UNDERWRITE MUNICIPAL REVENUE BONDS, SPONSOR UNIT INVESTMENT TRUSTS, AND DISTRIBUTE INVESTMENT COMPANY SECURITIES

This section amends section 16 of the Glass-Steagall Act, which now generally prohibits a national bank from underwriting, dealing in, or purchasing for its own account most types of securities. 12 U.S.C. § 24 (Seventh). There are more than 20 exceptions to that prohibition, the most important of them being for securities issued or guaranteed by the U.S. Government, and for general obligations of State and local governments.

Although section 16 deals directly only with national banks, it also affects the powers of State and member and nonmember banks. The Federal Reserve Act applies the restrictions of section 16 to State member banks. 12 U.S.C. § 335. Moreover, whatever is permitted under section 16 is not prohibited under section 21, which applies to member and nonmember banks alike. 12 U.S.C. § 378(a)(1). Accordingly, the amendments made by this section remove Federal prohibitions that would otherwise apply to State as well as national banks.

A. Underwriting Municipal Securities

This section amends section 16 to provide that a national bank may underwrite, deal in, and purchase for its own account any obligations issued or guaranteed by or issued on behalf of a State or any political subdivision, agency, or instrumentality of a State. In so doing, this section authorizes a national bank to underwrite and deal in municipal revenue bonds.

However, this section does not authorize a national bank to underwrite, deal in, or purchase for its own account private activity bonds (as defined in section 141 of the Internal Revenue Code of 1986), unless those bonds meet at least one of two tests:

(1) a State, territory, or possession of the United States, a political subdivision thereof, or the District of Columbia, pledges its full faith and credit for the repayment of the entire principal of and interest on the bonds; or

(2) the interest on the private activity bonds is exempt from Federal income tax, and the issuer—or the governmental unit on behalf of which the bonds were issued—is the sole owner, for Federal income tax purposes, of the facility to be financed.

B. Sponsoring Unit Investment Trusts

This section makes two additional exceptions to the general prohibition of section 16: one involves sponsoring unit investment trusts; the other involves distributing investment company securities. However, the exemptions are available only to national banks that are not affiliated with a securities affiliate pursuant to section 4(c)(15) of the Bank Holding Company Act.

A unit investment trust differs from a mutual fund in having no investment adviser and no board of directors—indeed, virtually no management. Securities issued by the trust represent an undivided interest in a portfolio of securities that is fixed when the trust is organized; the sponsor and the trustee have little or no investment discretion. See generally 15 U.S.C. § 80a-4(2) (definition of “unit investment trust” in Investment Company Act). Unit investment trusts commonly invest in long-term, fixed-rate securities, especially tax-exempt municipal bonds. They enable even relatively small investors to acquire an interest in a diversified portfolio of such securities.

The sponsor of a unit investment trust organizes and registers the trust, transfer's the trust's portfolio to a trustee or custodian in return for certificates representing an interest in the trust, and distributes those securities to investors. A bank or trust company holds title to the trust's assets pursuant to an agreement with the sponsor. Either the sponsor or the trustee provides administrative services such as bookkeeping, issuing certificates to investors, and reporting to regulators.

This section authorizes a national bank not affiliated with a securities affiliate to underwrite, deal in, or purchase for its own account securities of a unit investment trust, so long as the unit investment trust holds only securities that satisfy *both* parts of the following test:

(1) national banks must be specifically authorized by statute to underwrite those securities; and

(2) the securities must be expressly described in at least one of two ways:

(A) expressly described in the statute that specifically authorizes national banks to underwrite those securities; or

(B) expressly described in a regulation promulgated by the Comptroller of the Currency pursuant to that statute before November 18, 1987, as being authorized for a national bank to underwrite.

The foregoing two-part test is intended to ensure that the Comptroller cannot broaden the eligible class by administrative action. However, the test does not prevent the Comptroller from issuing interpretations seeking to clarify what securities are eligible for national banks to underwrite. See analogous discussion in Senate Report No. 368, 96th Cong., 1st Sess. 249 (1979), which stated that the Comptroller “shall not use . . . rulemaking authority, as opposed to interpretive rulings which are requested from time to time, to decide issues related to the Glass-Steagall Act.”

C. Distributing Investment Company Securities

This section also authorizes a national bank not affiliated with a securities affiliate to distribute securities issued by an investment company, so long as the investment company is not organized, sponsored, managed, or controlled by the bank or any affiliate of the bank. Under this provision, a national bank may not act as the principal underwriter of a mutual fund, but may obtain securities from the principal underwriter and distribute them to investors. An investment company is “organized” or “sponsored” by the bank

or affiliate if the bank or affiliate initiated or directed—or is initiating or directing—the investment company's organization. Cf. 15 U.S.C. § 2(a)(30) (definition of "promoter" in Investment Company Act). An investment is "managed" by the bank or an affiliate if the bank or affiliate acts as investment advisor to the investment company.

SECTION 109. AMENDMENTS TO THE INTERNATIONAL BANKING ACT OF 1978

Proposed section 4(c)(15)(C) of the Bank Holding Company Act (as added by section 102 of the bill) requires the Federal Reserve Board to disapprove any acquisition that would result in the affiliation of (1) a bank holding company or bank with total assets of more than \$30 billion with (2) an investment banking organization with total assets of more than \$15 billion. There are two narrow classes of acquisitions to which section 4(c)(15)(C) would not literally apply. This section is intended to ensure that foreign organizations cannot circumvent section 4(c)(15)(C) and then engage in the United States in both commercial banking and investment banking.

A. Acquisition of an Investment Banking Organization by a Foreign Bank or Parent Company With no Commercial Banking Presence in the United States

The first of the two classes involves the acquisition of a U.S. or foreign investment banking organization by a foreign bank—or a foreign company controlling a foreign bank ("parent company")—that has no commercial banking presence in the United States (i.e., no branch, agency, commercial lending company, or subsidiary bank). Section 4(c)(15)(C) would not literally apply because the acquisition would not require approval under section 4(c)(15) (assuming that the investment banking organization, like the foreign bank or parent company, had no commercial banking presence in the United States).

If the foreign bank could thereafter engage in the United States in both commercial banking and investment banking, it would have an unfair advantage over other foreign entities and over U.S. banks, bank holding companies, and investment banking organizations: the option of forming an affiliation not permitted under the concentration restrictions and the reaping the benefits of that affiliation in the United States. That possibility could arise if the foreign bank, having acquired the investment banking organization, sought to establish (or reestablish) a commercial banking presence in the United States. Although section 4 of the Bank Holding Company Act generally applies to the U.S. activities of a foreign bank that has such a presence, the foreign bank might argue that it could establish such a presence while retaining the affiliation with the investment banking organization. Specifically, the foreign bank might argue that section 4(c)(15)(C) merely prohibits an acquisition that "would result" in an impermissible affiliation—whereas the foreign bank's acquisition of the investment banking organization had already been lawfully consummated.

To foreclose that argument, this section amends the International Banking Act so as to prohibit a foreign bank or its parent com-

pany from establishing a commercial banking presence in the United States if:

(1) the foreign bank or parent company becomes affiliated with an investment banking organization after this becomes law;

(2) the affiliation would have violated section 4(c)(15)(C) if the foreign bank had been a bank holding company at the time of the acquisition;

(3) the affiliation has not been terminated, both in form and in substance; and

(4) the investment banking organization has an office or subsidiary in a State or in the District of Columbia.

Thus, if the affiliation continues, the foreign bank has a choice: it can have either a commercial banking or an investment banking presence in the United States, but not both.

B. Acquisition of a U.S. Bank or Bank Holding Company by a Foreign Investment Banking Organization When Neither Party Engages in the United States in Underwriting, Distribution, or Dealing

The second class of acquisitions to which section 4(c)(15) does not literally apply involves the acquisition of a large U.S. bank or bank holding company by a large foreign investment banking organization when, at the time of the acquisition, neither party to the acquisition engages in the United States in underwriting, distribution, or dealing. Although the foreign investment banking organization would be required to conform its activities to the requirements of section 4 of the Bank Holding Company Act, section 4(c)(15)(C) would not require disapproval because no application under section 4(c)(15) would be required at the time of the acquisition.

If at a later date, however, the foreign investment banking organization were to directly or indirectly establish an office or subsidiary in the United States under section 4(c)(15), the foreign investment banking organization might argue that section 4(c)(15)(C) would not require disapproval of the transaction because the transaction would not "result in" an impermissible affiliation. It is intended that this type of subsequent transaction should also be disapproved under section 4(c)(15).

In order to ensure, however, that a foreign investment banking organization cannot evade the restrictions of section 4(c)(15)(C), section 109(b) prohibits the foreign investment banking organization from acquiring or retaining control of a securities affiliate under section 4(c)(15) if the Board would have been required to disapprove the transaction by which the foreign investment banking organization became affiliated with the U.S. bank or bank holding company if an application under section 4(c)(15) had been required at that time. This section ensures that a large foreign organization cannot evade the requirements of the Act by first establishing an affiliation with a large U.S. banking organization and thereafter commencing investment banking activities in the United States. This prohibition applies only if the impermissible affiliation occurs after the bill becomes law and the affiliation has not been terminated.

Section 109, like section 4(c)(15)(B), cannot be evaded by structuring an acquisition as a purchase of assets.

SEC. 110. DIVERSIFIED FINANCIAL HOLDING COMPANIES

This section amends the Bank Holding Company Act so as to create a new category of holding companies: diversified financial holding companies. Section 110(a) defines "diversified financial holding company." The remainder of section 110 sets forth the powers and legal status of, and the restrictions applicable to, a diversified financial holding company, including: grandfather rights to continue to engage in certain financial activities that are impermissible for bank holding companies; exemption from certain examination and capital requirements; restrictions on certain joint marketing; and restrictions on certain transactions with affiliates.

A. Qualifying as a Diversified Financial Holding Company

Under section 110(a), a diversified financial holding company is a company that directly or indirectly controls a bank and that meets the following five-part test.

1. Engaging only in financial activities

The company must engage only in:

- (1) activities that are permissible for bank holding companies under section 4 of the Bank Holding Company Act; or
- (2) financial activities in which the company was engaged as of February 1, 1988. (The definition of "financial" is discussed below.)

2. 80-percent test

The company must have devoted 80 percent or more of its consolidated assets, on average during the preceding calendar year, to activities that are permissible under one or more of the following four provisions of the Bank Holding Company Act:

- (1) section 4(c)(8): activities that the Federal Reserve board has determined to be so closely related to banking as to be a proper incident to banking;
- (2) section 4(c)(13): activities of a company that does no business in the United States except as an incident to its international or foreign business;
- (3) section 4(c)(14): activities permissible for export trading companies; and
- (4) section 4(c)(15): securities activities.

An activity is permissible under a given provision only if it is conducted in compliance with any limitations imposed on bank holding companies by or pursuant to that provision.

Assets of FDIC-insured banks, FSLIC-insured thrift institutions, or subsidiaries of those banks or thrifts cannot be used to satisfy the 80-percent test.

3. 20-percent limit on federally insured depository institutions and their subsidiaries

The company's FDIC-insured subsidiary banks, FSLIC-insured thrift institutions, and any subsidiaries of those banks or thrifts

must together, on average during the preceding calendar year, have constituted 20 percent or less of the company's consolidated assets.

4. Global 40-percent limit on depository institutions and their subsidiaries

The company's subsidiary depository institutions and any subsidiaries of those institutions must together, on average during the preceding calendar year, have constituted 40 percent or less of the company's consolidated assets.

Included in the 40-percent figure are all U.S. banks, whether or not insured by the FDIC; all thrift institutions, whether or not insured by the FSLIC; all foreign banks; and all other depository institutions, whether or not located in the United States. The "other depository institutions" category would, for example, include foreign building and loan associations and Edge corporations that accept deposits; it would exclude entities that do not accept deposits, even if those entities have legal authority to accept deposits.

5. Election to be treated as diversified financial holding company

The company must file with the Federal Reserve Board a written notice of its intent to be treated as a diversified financial holding company.

B. Status and Applicable Law

Having defined "diversified financial holding company," this section adds to the Bank Holding Company Act a new section 4(i), setting forth the law applicable to such companies.

Section 4(i)(1) provides that a diversified financial holding company is not a bank holding company. This means that State laws that are keyed to whether a company is a "bank holding company" under the Bank Holding Company Act would not automatically apply to a diversified financial holding company.

Under section 4(i)(2), a diversified financial holding company is, with two exceptions, treated like a bank holding company for purposes of Federal statutes: any provision of the United States Code relating to bank holding companies applies to the diversified financial holding company in the same manner and to the same extent as it applies to bank holding companies. The two exceptions, discussed below, are (1) grandfather rights to continue to engage in any financial activity, and (2) exemption from normal bank holding company examination and capital requirements.

C. Intermediate Holding Companies

Like a bank holding company, a diversified financial holding company need not own a subsidiary bank's shares directly; it may hold those shares through one or more intermediate holding companies. Section 4(i)(3) deals with the status of those companies.

An intermediate holding company controlled by a diversified financial holding company is treated exactly the same as the parent company: it is not a bank holding company, but—with the two exceptions noted above—it is subject to any Federal statute relating to bank holding companies. Unlike the parent diversified financial

holding company, the intermediate holding company is not required to satisfy the 80-percent test or to comply with the 20-percent or 40-percent limitations; it is sufficient that the parent is in compliance on a consolidated basis.

D. Grandfather Rights to Continue to Engage in Nonconforming Financial Activities

Under section 4(i)(4), a diversified financial holding company may continue to engage in any financial activity described in section 4(i)(5) (discussed below) in which it was lawfully engaged in the United States, directly or through a subsidiary, as of February 1, 1988, even activities that are not permissible for bank holding companies ("nonconforming activities"). The only exception is for securities underwriting, distribution, and dealing, which must thus be conducted subject to the same restrictions as apply to bank holding companies. Thus, for example, a diversified financial holding company is bound by section 4(c)(15)(F) to the same extent as a bank holding company. Likewise, a diversified financial holding company may not underwrite equity securities unless bank holding companies may do so under section 4(c)(15)(K).

If a diversified financial holding company has grandfather rights to engage in a given financial activity, it may also acquire another company engaged in that activity.

The following activities are described in section 4(i)(5) and may thus be the subject of grandfather rights under section 4(i)(4): insurance underwriting, insurance agency and brokerage, real estate brokerage, real estate investment and development, and travel agency activities; and any other activities that the Federal Reserve Board has determined to be financial.

E. Exemption from Examination and Capital Requirements

Under section 4(i)(6), a diversified financial holding company and its nonbank subsidiaries are exempt from the normal inspection, examination, reporting, and capital requirements established by the Federal Reserve Board for bank holding companies. The Board may examine or require reports of a bank holding company and its nonbank subsidiaries in order to determine whether the parent company qualifies as a diversified financial holding company, and to assure compliance with the Bank Holding Company Act, the anti-tying provisions of the Bank Holding Company Amendments of 1970, and sections 23A and 23B of the Federal Reserve Act. The Board may also examine or require reports to assure that the safety and soundness of the bank holding company's subsidiary banks are not threatened by the activities or condition of the holding company or nonbank subsidiaries whenever the Board determines that emergency conditions exist which require such assurance.

F. Restrictions on Joint Marketing

A diversified financial holding company's subsidiary banks are subject to restrictions on joint marketing (also known as "cross-marketing"). Such a bank must not:

- (1) offer or market products or services of an affiliate that are not permissible for bank holding companies to provide

under section 4(c)(8) or 4(c)(15) of the Bank Holding Company Act; or

(2) permit its own products or services to be offered or marketed in connection with products or services of an affiliate that are not permissible for bank holding companies to provide under section 4(c)(8) or 4(c)(15).

The joint marketing restrictions are intended to minimize the unfair advantage that diversified financial holding companies might otherwise enjoy over bank holding companies.

G. Restrictions on Lending to Affiliates Engaged in Nonconforming Activities

If a subsidiary of a diversified financial holding company engages in any nonconforming financial activity pursuant to section 4(i)(4), that subsidiary is subject to section 4(c)(15)(F)(i) in the same manner and to the same extent as if it were a securities affiliate. (Section 4(c)(15)(F)(i), discussed above, generally prohibits a bank or thrift institution affiliated with a securities affiliate from extending credit to, purchasing financial assets from, or making guarantees for the benefit of the securities affiliate.) The same restrictions apply to the parent diversified financial holding company if it engages directly in a nonconforming financial activity pursuant to section 4(i)(4).

H. Divestiture of Subsidiary Banks

If a company elects to be treated as a diversified financial holding company and then fails to maintain the capital of each of its subsidiary banks at or above the minimum level required by the appropriate regulator, the Federal Reserve Board shall notify the company of the capital deficiency and give the company 30 days to restore capital to the required level. If the Board determines that the company is unable to restore the capital of a subsidiary bank to the required level, the Board may issue an order requiring the company to divest itself of the bank within 180 days of the date of the order.

SECTION 111. STUDY ON HARMONIZING THE REGULATION OF BANKING AND SECURITIES ORGANIZATIONS

This section includes a finding, study, agency consulting requirement, and agency reporting requirement on the need to harmonize the regulation of banking and securities organizations.

A. Finding

Subsection (a) is a congressional finding that the authorization of banking organizations to engage in securities activities and securities organizations to engage in banking activities calls for steps to be taken to promote competitive equity between the two. The Federal Reserve Board, the SEC, the Comptroller of the Currency, and the Commodity Futures Trading Commission are directed to review and coordinate their respective regulations accordingly.

B. Study

The agencies in question are directed to prepare a joint report within one year after the bill is enacted on the following seven issues: (1) the advisability of consolidated regulation of companies controlling banks or securities firms; (2) the appropriate techniques for supervising affiliate transactions within such firms; (3) the efforts to achieve international harmonization of the regulation of such firms; (4) the effect of financial activities outside the United States on securities activities and their regulation within the United States; (5) the advisability of establishing a permanent international framework to harmonize financial market regulation; (6) the nature and techniques used in supervising banking and securities organizations; and (7) the impact of financial services competition from firms that are neither banks nor securities firms.

C. Consultation

Subsection (c) directs the agencies in question to develop proposed revisions to harmonize the capital adequacy of banking and securities organizations using the recent international agreement among bank regulators as a model.

D. Reporting

Subsection (d) requires the agencies in question to submit an annual report to Congress regarding their progress towards, and recommendations for, achieving harmony of financial institution regulation as described in the Congressional finding under subsection (a).

SECTION 112. STUDY OF THE NATIONAL PAYMENTS SYSTEM

This section includes a congressional finding that the continued smooth and efficient functioning of the national payments system require consideration of the mechanism by which large dollar payments are made. Accordingly, the Federal Reserve Board is directed to prepare a study within one year of the date of enactment on the steps necessary to ensure the integrity and reliability of the large-dollar payments system in the United States.

SECTION 113. CONGRESSIONAL VOTE ON WHETHER OR NOT TO PERMIT SECURITIES AFFILIATES TO UNDERWRITE EQUITY SECURITIES

Under this section, Congress will vote on or before April 1, 1991, under expedited procedures, on whether or not to permit securities affiliates to underwrite, distribute, and deal in equity securities.

TITLE II—EXPEDITED PROCEDURES

SECTION 201. EXPEDITED PROCEDURES FOR FORMING A BANK HOLDING COMPANY

Section 3(a)(1) of the Bank Holding Company Act requires a company to receive the Federal Reserve Board's prior approval to acquire control of a bank and thereby become a bank holding company. 12 U.S.C. § 1842(a)(1). This section creates a simplified, 30-day-notice procedure for forming a bank holding company. The simplified procedure may be used if three conditions are satisfied.

First, the bank holding company must be formed through a reorganization in which existing shareholders of a bank exchange their shares for shares of the newly formed bank holding company and receive substantially the same proportional share interest in the holding company as they held in the bank. In applying this standard, changes in shareholders' proportional interests resulting from the exercise of dissenting shareholders' rights (e.g., to receive cash in lieu of shares in the bank holding company) are disregarded.

Second, the bank holding company must, immediately following the reorganization, meet the capital and other financial standards prescribed for such a bank holding company by the Board's regulations. But the Board may not require more capital for the holding company's subsidiary bank immediately following the reorganization than is required for a similarly sized bank that is not a subsidiary of a bank holding company.

Third, the bank holding company must not be engaged in nonbanking activities directly or through a nonbank subsidiary.

SECTION 202. EXEMPTION OF CERTAIN BANK HOLDING COMPANY FORMATIONS FROM REGISTRATION UNDER THE SECURITIES ACT OF 1933

The Securities Act generally requires securities to be registered with the SEC, but provides various exemptions from that requirement. 15 U.S.C. §§77d-77e. This section would add an exemption for offers or sales of equity securities made in connection with the formation of a bank holding under the simplified procedure established by section 201 of the bill. To be eligible for the exemption, the transaction must satisfy the first of the three conditions described above in connection with section 201.

SECTION 203. EXPEDITED PROCEDURES FOR BANK HOLDING COMPANIES TO SEEK APPROVAL TO ENGAGE IN NONBANKING ACTIVITIES

Section 4(c)(8) of the Bank Holding Company Act currently authorizes the Federal Reserve Board to permit bank holding companies to engage in activities "so closely related to banking or managing or controlling banks as to be a proper incident thereto." 12 U.S.C. §1843(c)(8). This section amends that standard by specifying that the Board, when making such a determination, shall also take into account technological or other innovations in the provision of banking or banking-related services.

In addition, section 203 provides new, streamlined procedures for bank holding companies seeking to engage in nonbanking activities under section 4(c)(8). Under these procedures, the bank holding company applicant must give the Board 60 days advance notice of its intent to acquire the shares of a company engaging in a nonbanking activity. The applicant may then proceed to complete the acquisition after the 60-day period expires, unless the Board issues an order disapproving the proposal, or extending the time period in order to obtain additional relevant information. Any such extension order may be reviewed in the appropriate court of appeals. The acquisition may take place before the 60-day period expires if the Board issues a written statement of its intent not to disapprove the application.

The notice required under this section shall contain such information as the Board may prescribe by regulation or by specific request, except that all information requested must be relevant to the nature and scope of the proposed activity and to the Board's evaluation of the activity.

In determining whether to disapprove a notice under this paragraph, the Board shall consider the same factors as under current law: i.e., whether the performance of the activity described in the notice by a bank holding company can reasonably be expected to produce public benefits (such as greater convenience, increased competition, or gains in efficiency) that outweigh possible adverse effects (such as undue concentration of resources, decreased or unfair competition, conflicts of interest, or unsound banking practices).

The Board shall by order set forth the reason for any disapproval of, or determination not to disapprove, a notice under this paragraph.

If a notice involves insurance activities, the Board shall publish in the Federal Register notice of receipt of the notice, shall provide a reasonable period for public comment on the notice, and shall issue an order regarding the notice.

Section 203 does not change the provisions of section 4(c)(8) relating to insurance activities of bank holding companies.

SECTION 204. REDUCTION OF POST-APPROVAL WAITING PERIOD FOR BANK HOLDING COMPANY ACQUISITIONS

Section 11(b)(1) of the Bank Holding Company Act (12 U.S.C. § 1849(b)(1)) generally imposes a 30-day waiting period on transactions approved by the Federal Reserve Board under section 3 of the Act. Such a transaction may involve a company's application to become a bank holding company by acquiring control of a bank or bank holding company; or may involve a bank holding company's application to acquire voting shares of a bank, to acquire the assets of a bank, or to merge or consolidate with another bank holding company. 12 U.S.C. § 1842(a). This 30-day waiting period, like the identical waiting period in the Bank Merger Act, is intended to permit the Department of Justice to obtain injunctions against an anticompetitive transaction before it is consummated. However, apart from certain emergency acquisitions of failing banks or bank holding companies, the 30-day waiting period applies *even if* the transaction in question would have no effect on competition and is not opposed by the Department of Justice.

This section would amend section 11(b)(1) so as to permit the Board, with the concurrence of the Attorney General, to shorten the 30-day waiting period. The requirement for the Attorney General's concurrence ensures that the Department of Justice can insist on the full 30-day waiting period if it has any qualms whatever about the transaction in question. The waiting period cannot, in any event, be less than 5 days. Moreover, the 30-day waiting period cannot be shortened if the Board or its delegate has received any timely, written adverse comment regarding section 4(c)(8)(C) or 4(j) of the Bank Holding Company Act—provisions which restrict insurance activities.

SECTION 205. REDUCTION OF POST-APPROVAL WAITING PERIOD FOR BANK MERGERS

An FDIC-insured bank needs approval under section 18(c) of the Federal Deposit Insurance Act (a provision commonly known as the "Bank Merger Act") to merge or consolidate with another bank, acquire the assets of another bank, or assume liability to pay any deposits of another bank. 12 U.S.C. § 1828(c). Under section 18(c)(6), most such transactions cannot be consummated before the thirtieth calendar day after they are approved. The purpose of the 30-day waiting period is "to give the Department of Justice an opportunity to enjoin" an anticompetitive transaction before it is consummated. H. Rep. No. 1221, 89th Cong., 2d Sess. 1 (1966). However, unless immediate action is needed to prevent the probable failure of one of the banks involved, the 30-day waiting period applies even if the transaction in question would have no effect on competition and is not opposed by the Department of Justice.

This section would amend section 18(c)(6) so as to permit the appropriate Federal banking agency, with the concurrence of the Attorney General, to shorten the 30-day waiting period. The requirement for the Attorney General's concurrence ensures that the Department of Justice can insist on the full 30-day waiting period if it has any qualms whatever about the transaction in question. The waiting period cannot, in any event, be less than 5 days.

SECTION 206. AMENDMENTS TO THE DEPOSITORY INSTITUTION MANAGEMENT INTERLOCKS ACT

Section 206 makes five changes to the Depository Institution Management Interlocks Act. The Act restricts management officials of a depository institution (or its holding company) from serving as management officials of certain unaffiliated depository institutions (or their holding companies).

A Definition of Affiliation

Section 206(a) revises the test for "affiliation." The Interlocks Act currently provides that two depository institutions are affiliated—and thus exempt from the Act's prohibitions—if more than 50 percent of the voting stock of one institution is beneficially owned in the aggregate by one or more persons who also beneficially own in the aggregate more than 50 percent of the voting shares of the other institution. 12 U.S.C. § 3201(3)(B). Section 206(a) changes this test by lowering the common ownership threshold from 50 percent to 25 percent.

B. Advisory and Honorary Directors

The Interlocks Act currently treats advisory and honorary directors the same as other directors. 12 U.S.C. § 3201(4). That treatment reflects a concern that interlocks involving advisory or honorary directors could facilitate anticompetitive collusion. Section 206(b) exempts from the Act's prohibitions advisory and honorary directors of depository institutions with assets of less than \$100 million. A person is not an "advisory or honorary" director for purposes of this provision if he or she (1) participates or has the right to participate in meetings of the board of directors or in any policymaking

functions of the depository institution; or (2) participates or has the right to participate in day-to-day operational decisions, or attends meetings (e.g., of a credit committee) at which such decisions are made.

C. Exemption for Failed or Failing Institutions

Section 206(c) provides a five-year exemption from the prohibitions of the Interlocks Act for a depository institution or holding company that closes, or is in danger of closing (as determined by the principal Federal regulator of that institution or holding company), and is acquired by another depository institution or holding company. Five years after the acquisition, the exemption will no longer apply.

D. Exception for Diversified Savings and Loan Holding Companies

Section 206(d) establishes an exemption from the Interlocks Act for diversified savings and loan holding companies, pursuant to which a director of an unaffiliated depository institution or holding company may also serve as a director of the diversified savings and loan holding company (but not as a director of the holding company's subsidiary depository institutions).

Under this exemption, the primary Federal supervisors of the depository institutions involved must be given 60 days advance notice of the proposed dual service. Either regulator may object, and thus prevent the dual service, if it finds that the dual service raises certain antitrust, conflict of interest, or safety and soundness concerns. Dual service may also be prohibited if the unaffiliated depository institutions involved are found to be in substantial competition with each other in the primary metropolitan statistical area in which the diversified savings and loan company's subsidiary depository institution is located.

E. Extension of Grandfather Clause

Section 206(e) extends the grandfather provision in the Interlocks Act. The Act currently grandfathers management officials whose service began before the enactment of the original Interlocks Act, as well as certain other management officials. 12 U.S.C. § 3205. These grandfather rights are currently set to expire on November 10, 1988. Section 206(e) extends these grandfather rights for an additional five years.

SECTION 207. BANKERS' BANKS AND BANKERS' BANK HOLDING COMPANIES

A bankers' bank is a bank that is owned by other depository institutions, directly or through a bankers' bank holding company, and is organized to engage exclusively in providing services to other depository institutions or their officers, directors, or employees. A bankers' bank holding company is a company that controls a bankers' bank and is itself controlled by depository institutions or their holding companies. Through a bankers' bank, a group of banks can provide services to themselves that they might otherwise have to purchase from correspondent banks.

A. Ownership of Bankers' Banks by National Banks

Section 207(a)(1) provides that a national bank may own the stock of a bankers' bank or a bankers' bank holding company is that bankers' bank or holding company is owned exclusively by either banks or holding companies. (Current law does not clearly permit national banks to own stock in bankers' banks or bankers' bank holding companies that are owned by holding companies.)

Section 207(a)(2) makes clear that a bankers' bank chartered by the Comptroller of the Currency may be organized within a holding company provided that the holding company for the bankers' bank is owned by depository institutions and their holding companies. This section also clarifies that such a bankers' bank may provide services to shareholders that are depository institutions themselves. (Current law does not clearly permit bankers' banks chartered by the Comptroller of the Currency to provide services to holding companies.)

B. Bankers' Banks and Deposit Insurance

Section 207(b) changes a cross reference in section 3(e) of the Bank Holding Company Act, 12 U.S.C. § 1842(e). Before the passage of the Competitive Equality Banking Act, section 3(e) referred to banks mentioned in the "last sentence of section 2(c)" of the Bank Holding Company Act, i.e., bankers' banks. Since section 2(c) was completely rewritten by the Competitive Equality Banking Act, it is necessary to substitute another statutory reference to bankers' banks to clarify that bankers' banks organized within a bank holding company are not required to carry FDIC insurance because these institutions do not accept deposits from the public.

C. Limit on Loans Secured by Securities

Section 207(c) permits the Federal Reserve Board to increase the limit for member banks on loans secured by stock or bond collateral to any one person to 15 percent of a bank's unimpaired capital and surplus. This enables the Board to conform this limit to a similar level established in the Garn-St Germain Act for secured loans made by national banks.

TITLE III—BROKERS AND DEALERS

SECTION 301. DEFINITION OF BROKER

The Securities Exchange Act of 1934 (the "Exchange Act") currently excludes banks from the definition of "broker." As a result, a bank may currently engage in permissible securities activities directly, subject to regulation by the appropriate bank regulator, but is not subject to regulation by the Securities and Exchange Commission under the Exchange Act. The SEC's Rule 3b-9, issued in 1985, would have subjected banks to Exchange Act regulation, but a U.S. court of appeals held that the rule was beyond the SEC's statutory authority. *American Bankers Association v. Securities and Exchange Commission*, 804 F.2d 739 (D.C. Cir. 1986).

Section 301 amends the Exchange Act's definition of "broker" to include banks under certain specific circumstances and subject to certain specific exemptions. This is consistent with other sections of

the bill that promote functional regulation: the SEC will regulate securities activities as a general rule, but the bank regulators will continue to regulate certain securities activities that are closely connected to traditional banking activities.

Section 301 achieves this result by amending the definition of "broker" to exclude a bank except when the bank "publicly solicits" brokerage business or receives "incentive compensation" for brokerage. A bank covered by either of these exceptions will be subject to broker-dealer registration and regulation under the Exchange Act unless the brokerage activities fall within the exemptions described below.

If the bank is covered, it will be required under section 304 to spin out its public brokerage business into a separate corporate entity, which—for purposes of this section—includes an operating subsidiary of the bank or a subsidiary of the parent bank holding company established under section 4(c)(8) or 4(c)(15) of the Bank Holding Company Act. (The restrictions imposed on a 4(c)(15) securities affiliate do not apply to a subsidiary of the bank or to a 4(c)(8) subsidiary of the bank holding company.)

The term "publicly solicits" is to be broadly interpreted, and includes not only general advertisements or public telephone solicitation, but also systematic solicitation of existing customers through such items as materials included with bank statements.

"Incentive compensation" is the payment of commissions or similar remuneration based on effecting transactions in securities, in excess of the bank's incremental costs directly attributable to effecting such transactions. "Incentive compensation" does not include fees calculated on a basis unrelated to or unconnected with effecting transactions in securities, such as, for example, an annual administration charge or an hourly charge for fiduciary consulting services, or fees calculated as a percentage of assets under management.

As mentioned above, section 301 also includes certain specific exemptions. These recognize that certain bank brokerage activities are closely allied to traditional bank functions that already are subject to extensive regulation and supervision by the Federal banking agencies. Specifically, section 301 includes nine exemptions that allow a bank to continue engaging in such brokerage activities directly in the bank without being deemed a "broker" under the Exchange Act, and without being subject to SEC regulation.

A. Networking Exemption

A bank will not be deemed a "broker" because of transactions in connection with a "networking" arrangement. This occurs where a bank contracts with a registered broker-dealer, whether or not affiliated with the bank, to provide brokerage services on bank premises on a fully disclosed basis. However, bank employees engaged in this activity whose functions are other than clerical or ministerial, or who are compensated on a commission basis, must be suitably qualified and regulated as securities registered representatives. Whether or not such employees are so qualified, however, the bank itself could receive commissions without losing the exemption, as permitted under Rule 3b-9.

B. Trust Activities Exemption

A bank will not be deemed a "broker" because of trust activities, including brokerage, unless the bank receives incentive compensation *and* publicly solicits brokerage business other than by advertising, in conjunction with advertising its other trust activities, that it effects transactions in securities.

However, securities transactions for other types of fiduciary accounts will not be exempt, and a bank engaging in them could be deemed a "broker" if it satisfied the general definition in section 301. Specifically, the exemption does not apply to securities safekeeping, self-directed individual retirement accounts, or managed agency or other functionally equivalent accounts of a bank; a bank engaging in securities activities in connection with these accounts would be deemed a "broker" if it publicly solicited such business or received incentive compensation for such activities.

The Committee does not intend by this exclusion, however, to require these accounts to be moved from a bank. It is only intended that the bank may not publicly solicit brokerage business for such accounts or directly or indirectly receive transaction related compensation for such accounts, without transferring the activities to a subsidiary or affiliate. It is contemplated that any brokerage activity in connection with such accounts will be conducted by an independent broker-dealer or affiliated broker-dealer of the bank and that no part of the fees received by such broker-dealer will be shared with the bank.

With regard specifically to a securities safekeeping account, while the bank's role is that of custodian or depository, securities safekeeping services often are provided by brokers and banks that also execute transactions in that security on behalf of the same customer. To the extent, however, that a bank provides custodial services without execution, a bank would not be a "broker." An example of such an exempt arrangement would be a safe deposit box, where a customer might deposit securities with a bank, but effecting transactions in those securities would not be inherent in the relationship. Other examples would include escrow arrangements and holding securities as collateral for loans.

C. Exemption for Transactions in Certain Securities

A bank will not be deemed a "broker" because of transactions in certain specific types of securities. These are: (a) securities that are defined as "exempted securities" under the Exchange Act—such as U.S. Government securities—but excluding municipal securities, which are subject to the separate exemption described below; (b) commercial paper; (c) bankers' acceptances; and (d) commercial bills.

D. Municipal Securities Exemption

A bank that does not have a securities affiliate under new section 4(c)(15) of the Bank Holding Company Act will not be deemed a "broker" because of transactions in municipal securities. The exemption applies to transactions in both general obligation bonds, which banks have long been authorized to underwrite and deal in,

and public purpose revenue bonds, which banks are specifically authorized to underwrite and deal in under section 108 of the bill.

A bank that does have a securities affiliate, however, would not receive this exemption. As a result, if it otherwise fell within the definition of "broker" it would be required to spin out its municipal securities brokerage activities, including its revenue bond and general obligation bond brokerage activities, into a bank subsidiary or affiliate that is registered as a broker-dealer. This could be a subsidiary of the bank or a holding company affiliate established pursuant to either section 4(c)(8) or section 4(c)(15) of the Bank Holding Company Act.

E. Employee Benefit Account Exemption

A bank will not be deemed a "broker" because of transactions for employee benefit accounts. Such accounts include bonus, profit-sharing, pension, retirement, thrift, savings, incentive, stock purchase, stock ownership, stock appreciation, stock option, dividend reinvestment, or similar plans.

F. Money Market Sweep Account Exemption

A bank will not be deemed a "broker" because of transactions that sweep depositors' funds into money market accounts.

G. Affiliate Transaction Exemption

A bank will not be deemed a "broker" because of transactions for the account of any affiliate, as that term is defined in the Banking Act of 1933.

H. Private Placement Exemption

A bank will not be deemed a "broker" because of its role in placing primary offerings of securities by an issuer, not involving a public offering, to two classes of purchasers:

- (1) specified institutional investors, such as banks, insurance companies, investment companies, thrifts, State and local governments, charitable organizations, and certain foreign entities; and

- (2) individuals with a net worth exceeding \$5 million—an amount which is adjusted annually for inflation.

With respect to the second class, a bank would not lose the exemption if a particular purchaser did not meet the net worth requirement so long as the bank reasonably believed that the purchaser met that requirement.

This exemption is intended to preserve certain existing bank private placement functions.

I. Under 1,000 Transactions Exemption

A bank will not be deemed a "broker" if it limits its brokerage activities to fewer than 1,000 transactions per year (other than those transactions described in the other eight exemptions from the "broker" definition) and if it does not have a separate registered broker-dealer, regardless of whether it is a bank operating subsidiary or holding company affiliate established pursuant to either sections 4(c)(8) or 4(c)(15) of the Bank Holding Company Act.

J. Effect of Exemptions

The exemptions from the definition of "broker" are concerned with registration and regulation as a broker under the Exchange Act. They are not grants of authority, and do not affect any restrictions applicable under the Federal banking laws. The exemptions should not be used to draw inferences about the Federal banking laws, including the provisions added by title I of the bill.

SECTION 302. DEFINITION OF DEALER

Section 302 is a complementary amendment to the Exchange Act concerning the definition of "dealer." Like the current definition of "broker," the current definition of "dealer" in the Exchange Act specifically excludes banks. This section includes banks under the general definition of "dealer"—"any person engaged in the business of buying and selling securities for this own account through a broker or otherwise"—but creates four specific exemptions for banks that are similar to the "broker" exemptions.

A. Exemption for Transactions in Certain Securities

A bank will not be deemed a "dealer" because of transactions in certain specific types of securities. These are: (1) commercial paper; (2) bankers' acceptances; (3) commercial bills; and (4) securities that are defined as "exempted securities" under the Exchange Act—such as U.S. Government securities—but excluding municipal securities, which are subject to the separate exemption described below.

B. Municipal Securities Exemption

A bank that does not have a securities affiliate under new section 4(c)(15) of the Bank Holding Company Act will not be deemed a "dealer" because of transactions in municipal securities. As with the similar "broker" exemption, this applies to transactions in both general obligation bonds and revenue bonds. However, a bank that does have a securities affiliate will not receive this exemption, and will therefore be required to spin out its municipal securities dealing activities into a registered broker-dealer subsidiary or affiliate.

C. Trust Activities Exemption

A bank will not be deemed a "dealer" because it engages in trust or fiduciary activities, including buying and selling securities for investment purposes in the course of those activities.

D. Securitization Exemption

A bank will not be deemed a "dealer" because it engages in the issuance or sale of securities backed by or representing an interest in obligations originated or purchased by the bank, its affiliates, or its subsidiaries, provided that the underlying obligations are not third-party securities. This exemption for the "securitization" of bank assets recognizes that this function, to the extent that it may be permissible under the Federal banking laws, is closely connected to traditional banking activities (e.g., lending) and therefore should not be subject to Exchange Act broker-dealer regulation. In adopting the exemption, the Committee takes no position on the extent

to which the Federal banking laws may permit a bank to engage in activities covered by the exemption.

Section 302 preserves the existing distinctions between dealer activities on the one hand, and non-dealer principal transactions on the other hand (including bank investment and trading portfolio transactions for its own account or as a trustee or fiduciary), as reflected in current SEC interpretive positions.

E. Effect of Exemptions

The exemptions from the definition of "dealer" are concerned with registration and regulation as a dealer under the Exchange Act. They are not grants of authority, and do not affect any restrictions applicable under the Federal banking laws. The exemptions should not be used to draw inferences about the Federal banking laws, including the provisions added by title I of the bill.

SECTION 303. POWER TO EXEMPT FROM THE DEFINITIONS OF BROKER AND DEALER

This section authorizes the SEC to exempt—by rule, regulation, or order—any person or class of persons from the definition of "broker" or "dealer" if the SEC finds that the exemption is consistent with the public interest, the protection of investors, or the purposes of the Exchange Act.

SECTION 304. REQUIREMENT THAT BANKS FALLING WITHIN THE DEFINITIONS OF BROKER OR DEALER PLACE THEIR SECURITIES ACTIVITIES IN A SEPARATE CORPORATE ENTITY

This section amends the general registration requirement for brokers and dealers under the Exchange Act to prohibit a bank from becoming a broker or dealer, except on an exclusively intra-state basis. This change is intended to require banks that come under the revised definitions of "broker" and "dealer" in the Exchange Act to create a separate affiliate or subsidiary to perform these activities. Consistent with the general purposes of this legislation, this section would not restrict the substantive authority of any bank or bank holding company, under the national banking laws or any State banking law provision, to offer through an affiliate or subsidiary any permitted securities brokerage and dealing services.

Under this section, banks could engage in activities as a "broker" or "dealer" either through an affiliate or a subsidiary. For those activities not required to be conducted in a securities affiliate pursuant to section 4(c)(15) of the Bank Holding Company Act, banking organizations will—insofar as this section is concerned—be allowed the organizational flexibility to select the corporate form through which they would offer brokerage and dealing services. This would include a bank operating subsidiary, a non-bank affiliate established under Bank Holding Company Act section 4(c)(8), or a section 4(c)(15) securities affiliate.

It is intended that a bank be permitted, subject to applicable SEC registration and other requirements, to establish an operating subsidiary to engage in broker-dealer activities that are permissible for banks under section 16 of the Glass-Steagall Act but that may not

be conducted directly in the bank because of section 304 of the bill. Accordingly, the second sentence of section 304(a)(2) provides that the prohibition on a bank's conducting broker-dealer activities directly does not preclude the bank from establishing a subsidiary to conduct those activities. Those activities must, however, be activities that the bank could conduct directly but for section 304.

TITLE IV—BANK INVESTMENT COMPANY ACTIVITIES

SECTION 401. CUSTODY OF INVESTMENT COMPANY ASSETS BY AFFILIATED BANKS

Section 401 amends the Investment Company Act of 1940 to provide the SEC with rulemaking authority over certain situations involving banks affiliated with management investment companies (i.e., mutual funds and closed-end investment companies) and unit investment trusts.

Subsection (a) amends section 17(f) of the Investment Company Act to clarify and strengthen the SEC's authority to adopt regulations governing how banks may serve as custodians of affiliated management investment companies. Specifically, a registered investment company is permitted to place its assets with a bank that is an affiliated person, promoter, sponsor, organizer, or principal underwriter for such a company only in accordance with rules that the SEC may adopt after written consultation with the appropriate Federal banking agencies.

Subsection (b) amends section 26(a) of the Investment Company Act. That provision, among other things, prohibits a principal underwriter or depositor of a unit investment trust from selling securities issued by the trust unless the trust, by appropriate agreement, designates a bank meeting certain qualifications as trustee. The amendment would allow a unit investment trust to designate an affiliated bank as trustee only in accordance with rules that the SEC may adopt after written consultation with the Federal banking agencies.

SECTION 402. AFFILIATED TRANSACTIONS

This section prohibits an investment company from knowingly acquiring securities during an underwriting where the proceeds will be used to retire indebtedness to an affiliated bank. Specifically, section 10(f) of the Investment Company Act is amended to prohibit a registered investment company from knowingly purchasing or acquiring, during the existence of an underwriting or selling syndicate, any security (except a security of which it is the issuer) the proceeds of which will be used to retire indebtedness owed to a bank where the bank or its affiliate is an affiliated person, promoter, sponsor, organizer, or principal underwriter of the investment company.

SECTION 403. BORROWING FROM AN AFFILIATED BANK

Section 403 prohibits a mutual fund from borrowing from an affiliated bank except pursuant to certain SEC regulations. Specifically, section 18(f) of the Investment Company Act is amended to prohibit an open-end investment company (i.e., a mutual fund)

from borrowing from a bank if that bank or any affiliated person of the bank is an affiliated person, promoter, sponsor, organizer or principal underwriter of or for that investment company, except pursuant to rules and regulations of the SEC allowing such borrowing which the SEC finds to be in the public interest and consistent with the protection of investors.

SECTION 404. INDEPENDENT DIRECTORS

This section amends two provisions of the Investment Company Act to strengthen its requirements for independent directors serving on the boards of investment companies.

Subsection (a) amends the definition of "interested person" in section 2(a)(19)(A) of the Investment Company Act to include any person, including a bank, that is not a registered broker-dealer but which nevertheless engages in securities transactions or has certain other significant relationships with an investment company. Specifically, the amended definition includes a person (or any affiliate of a person) that acts as custodian or transfer agent or effects portfolio transactions for, engages in principal transactions with, or loans money to, an investment company or any other investment company in the same investment company "complex" within the preceding six-month period.

For example, officers, directors, or employees of a bank or other financial services provider that effects transactions in Government or municipal securities for an investment company without broker-dealer registration would become "interested persons" of that investment company. Such persons would not be prevented from serving as directors of that investment company; rather, they merely would be considered "interested persons" for purposes of the required percentage of disinterested or independent directors of that investment company. The amendment is effective one year after the date of enactment of the bill.

The change also clarifies the status of foreign broker-dealers under section 2(a)(19) that execute portfolio transactions for U.S. registered investment companies investing in foreign markets, but that are not registered as broker-dealers under the Exchange Act. The current definition of "interested person" refers only to SEC-registered broker-dealers. As a result, officers, employees, and directors of a foreign broker-dealer are not automatically disqualified from serving as independent directors of a registered investment company, even if the broker-dealer effects portfolio transactions for the investment company. This amendment clarifies this situation by including such broker-dealers (and their affiliated persons) within the definition of "interested person."

Subsection (b) amends section 10(c) of the Investment Company Act, which currently provides that no registered investment company may have a majority of its board of directors consisting of persons who are officers, directors, or employees or any one bank. The amendment extends the prohibition to the officers, directors, or employees of any one bank and its subsidiaries, or any one bank holding company and its affiliates and subsidiaries. This eliminates the potential to circumvent the legislative intent of section 10(c) by a bank operating under a multiple bank holding structure.

SECTION 405. ADDITIONAL SEC DISCLOSURE AUTHORITY

This section prohibits an investment company from representing that it or its securities are federally insured or guaranteed by federally insured banks or thrifts. Specifically, section 35(a) of the Investment Company Act is amended to prohibit a registered investment company or persons who sell securities issued by a registered investment company from representing or implying that the company or security is insured by the FDIC or FSLIC or is guaranteed by or is otherwise an obligation of any insured institution.

The SEC is also authorized to require persons who issue or sell securities of an investment company, and have specified relationships with a bank or bank holding company, to disclose prominently that the company and any security issued by it are not: (1) insured by the FDIC or FSLIC; (2) guaranteed by an affiliated bank or insured institution; or (3) otherwise an obligation of that bank or institution. This provision is similar to the requirement under new section 4(c)(15)(F)(vii) of the Bank Holding Company Act, which applies to securities affiliates.

The SEC is required to consult in writing with the appropriate Federal banking agencies before adopting such regulations. It should also specifically consider the disclosure rules contained in 12 C.F.R. part 337, which apply in connection with affiliations between FDIC-insured nonmember banks and companies engaged in certain securities businesses.

Section 405 is not intended to affect the Commission's authority under other provisions of the Federal securities laws to require disclosure, such as section 5 of the Securities Act of 1933.

SECTION 406. DEFINITION OF BROKER

This section amends the definition of "broker" in section 2(a)(6) of the Investment Company Act to reflect the bill's amended definition of that term in the Securities Exchange Act. The new definition would, however, continue to exclude any person (including a bank) solely by reason of the fact that such person is an underwriter for one or more investment companies.

SECTION 407. DEFINITION OF DEALER

Similarly, this section amends the definition of "dealer" in section 2(a)(11) of the Investment Company Act to reflect the bill's amended definition of that term in the Securities Exchange Act. The new definition would continue to exclude insurance companies and investment companies.

SECTION 408. REMOVAL OF THE EXCLUSION FROM THE DEFINITION OF INVESTMENT ADVISER FOR BANKS THAT ADVISE INVESTMENT COMPANIES

This section amends section 202(a)(11) of the Investment Advisers Act of 1940 ("Adviser Act") to remove the current exclusion from the definition of "investment adviser" for a bank or bank holding company that serves as an investment adviser to a registered investment company. This does not mean, however, that a bank is required to establish a separate subsidiary or affiliate in order to reg-

ister as an investment adviser (although it would be permitted to do so). Instead, a bank would be permitted to establish a separately identifiable department or division to perform this function, in which case only the department or division, and not the bank or bank holding company, would be required to register. The SEC would have the same regulatory authority over such a bank department or division as it has over other investment advisers.

This removal of the bank exclusion is intended to strengthen the SEC's ability to oversee the activities of registered investment companies. It is also intended to subject banks and bank holding companies that advise investment companies to the Advisers Act restrictions on performance fees, as well as agency cross and principal transactions. As a result, the SEC's regulatory authority over a bank or its departments or divisions would extend only to investment advisory services provided to registered investment companies and not to other advisory services.

SECTION 409. DEFINITION OF BROKER

This section amends the definition of "broker" in section 202(a)(3) of the Advisers Act to make it identical to the definition of "broker" in the Securities Exchange Act, as amended by this legislation.

SECTION 410. DEFINITION OF DEALER

This section amends the definitions of "dealer" in section 202(a)(7) of the Advisers Act to make it identical to the definition of "dealer" in the Securities Exchange Act, as amended by this legislation, except that it does not include an insurance company or an investment company.

SECTION 411. NOTIFICATION AND CONSULTATION

This section requires the SEC to notify the appropriate Federal banking agency before initiating any examination, investigation, or enforcement action against any bank holding company, bank, or department or division of a bank registered or required to be registered under the Advisers Act. The only exception to this requirement would be in a situation in which the protection of investors required immediate SEC action, in which case the SEC would notify the banking regulator as promptly as possible. In addition, the SEC and the Federal banking regulators are required to share those portions of examination reports covering bank and bank holding companies' investment advisory functions that are subject to the Advisers Act.

The notification and sharing requirements will diminish the possibility of redundant or duplicative regulation. This is necessary in view of the comprehensive examination and supervision authority that the banking agencies have over bank advisory activities, and the fact that many State and Federal fiduciary protections currently apply to many bank investment advisory functions. However, the notification and sharing requirements are not intended to limit the SEC's discretion to conduct examinations or investigations, or to institute enforcement actions. These provisions are also not intended to require Commission notification and consultation with

respect to bank activities that would not require registration under the Advisers Act.

SECTION 412. PUBLICITY

This section amends section 210(b) of the Advisers Act to expressly authorize the Commission to share information with Federal banking regulators and other Federal and State agencies for law enforcement and regulatory purposes. This section also authorizes information-sharing with self-regulatory organizations and foreign governments for the same purposes.

TITLE V—ENFORCEMENT POWERS IMPROVEMENT ACT

SECTION 501. SHORT TITLE

This section designates this title as the "Enforcement Powers Improvement Act of 1988."

SECTION 511. AMENDMENTS TO THE FEDERAL DEPOSIT INSURANCE ACT

Section 511(a)(1)

This section deletes references to officers, directors, employees, and other persons participating in the affairs of an insured bank and substitutes instead the phrase "institution-related party." As defined in section 511(a)(12) of the bill, an "institution-related party" encompasses all of the parties described above as well as persons who have filed or are required to file a change in control notice.

Section 511(a)(2)

This section amends section 8(b)(1) of the Federal Deposit Insurance Act to address a problem caused by a decision of the U.S. Court of Appeals for the Seventh Circuit in *Larimore v. Conover*, 789 F.2d 1244 (7th Cir. 1986). In that case the court ruled that section 8(b) of the Act did not authorize the Comptroller of the Currency to obtain reimbursement in an administrative proceeding from a director of a national bank who participated in a violation of the lending limits of the National Bank Act, but where there were no allegations of unjust enrichment or insider abuse. Instead, the court held that such actions must be brought directly in the U.S. district court, pursuant to 12 U.S.C. § 93.

The *Larimore* decision has resulted in some confusion about whether or not it applies in situations where there are allegations of insider abuse or unjust enrichment. This section of the bill would remedy this problem by specifying that the banking agencies may order restitution or reimbursement from an institution-related party, and would thus allow the recovery of losses resulting from violations of law or other improper conduct.

It is the Committee's intent, however, that this power be used only in cases where the institution-related party had unjustly enriched himself at the institution's expense or had acted in reckless disregard of the banking laws or regulations or of prior agency orders. This authority is not to be interpreted as otherwise permitting the agency to use a cease-and-desist proceeding to order an individual to pay damages for losses to the institution. The Commit-

tee does not intend that this provision confer unlimited authority on the bank regulatory agencies to impose money damages without appropriate safeguards.

This section would also clarify existing authority of the banking agencies to use a cease-and-desist order to limit the activities or functions of an individual or bank thus enabling the agencies to prevent specific practices or conduct without having to completely remove an individual from banking.

Section 511(a)(3)

This section clarifies that a temporary cease-and-desist order may place limitations on the activities or functions of the bank or party involved, similar to the clarifying amendment made in section 511(a)(2) above.

Section 511(a)(4)

This section expands the agencies' authority to issue temporary cease-and-desist orders in situations where the books and records of a bank or bank holding company are in such disarray that the appropriate agency cannot determine the condition of the bank or bank holding company or the nature of any transaction.

Section 511(a)(5)

This section revises subsections (e)(1) and (e)(2) of section 8 of the Federal Deposit Insurance Act into one unified provision for the removal of an institution-related party who has engaged in certain improper conduct with respect to any insured bank or other business enterprise. The bill also clarifies that a removal order may extend to any insured bank.

Section 511(a)(6)

This section amends current section (e)(4) by redesignating it as section (e)(3), and by extending its coverage to include all institution-related parties.

As a technical correction, the term "suspension notice" is changed to "suspension order," which conforms with the terminology used in section 8(e)(3).

Section 511(a)(7)

Used current law, it is a criminal offense for an individual removed or suspended or prohibited from participating in the affairs of an insured bank to participate in the affairs of another insured bank without the prior approval of the appropriate Federal agency.

This section of the bill provides that in the event an individual is removed, suspended or prohibited from participating in the affairs of an insured bank, a bank holding company, or other institution referred to in this section, he is also removed, suspended, or prohibited from all federally insured depository institutions, all bank holding companies, and other institutions referred to (unless otherwise approved by the appropriate Federal regulatory agency). Thus, under this provision, it would no longer be necessary for an agency to initiate a separate enforcement proceeding in order to remove an individual who has already been removed from a federally in-

sured institution, and the coverage of the cross-removal provision has been broadened to include thrift institutions.

Section 511(a)(8)

This section is merely a technical renumbering provision.

Section 511(a)(9)

This section clarifies the existing authority of the regulatory agencies to pursue sanctions, including removal, against an individual who has resigned from an institution, and thus would prevent an institution-related party from trying to thwart an enforcement action by simply resigning.

Section 511(a)(10)

This section amends the current provision authorizing the imposition of civil money penalties to provide that in addition to the current grounds, civil money penalties may also be assessed for violations of conditions imposed in writing by the Federal banking agencies.

Section 511(a)(11)

This section amends section 8(j) of the Federal Deposit Insurance Act to clarify that, without the prior approval of the appropriate Federal banking agency, an individual who is the subject of a suspension or removal order cannot be an officer of or participate in the affairs of another depository institution or holding company. Such an individual would be prohibited from participating in the affairs of not only insured banks, but any of the depository institutions or holding companies referred to.

Section 511(a)(12)

This section amends the definitional subsection (k) as follows:

Paragraph (1) defines "appropriate Federal regulatory agency," to include the FHLBB, the FSLIC, the Farm Credit Administration, and the NCUA, in addition to the banking agencies.

Paragraph (2) revises the definition of "cease-and-desist order which has become final" and "order which has become final" to include the new phrase "institution-related party."

Paragraph (3) defines an "institution-related party" to include all of the positions originally set forth in the law (e.g., officer, director, etc.) and is expanded to include a person who has filed or is required to file a notice under the Change in Bank Control Act.

Paragraph (4) revises the definition of the term "insured institution" to include a depository institution whose accounts are insured by the FSLIC or NCUSIF in addition to the FDIC.

Paragraph (5) retains the current definition of the term "violation."

Section 511(a)(13)

This section makes it clear that the enforcement authority granted in section 8 of the Federal Deposit Insurance Act is in addition to, and not limited by, any other statutory grant of authority, as provided by either Federal or State law. Thus, it modifies, in part, the *Larimore* decision with respect to the use of district court pro-

ceedings in lieu of administrative action undertaken under section 1818.

Section 511(b)

Section 19 of the Federal Deposit Insurance Act currently imposes a civil fine of up to \$100 per day on an insured bank for willfully employing an individual in certain capacities if that person was convicted of a crime involving dishonestly or breach of trust, without prior regulatory approval. This section increases the penalty to \$1,000 per day, and makes it applicable to both the bank and the employee. It also changes the intent requirement from "willful" to "knowing."

SECTION 512. PENALTY FOR VIOLATION OF CHANGE-IN-BANK CONTROL ACT

This section provides that instead of subjecting civil money penalty assessments under the Change in Bank Control Act to *de novo* review in U.S. district court, such assessments are reviewable, as are civil money penalties assessed under other statutes, pursuant to the procedures found in the Administrative Procedures Act.

This section also eliminates the requirement that the regulatory agencies demonstrate that a violation of the Change in Bank Control Act was "willful" in order to assess a civil money penalty, thus conforming that Act to other banking provisions which provide for civil money penalties.

SECTION 513. REPORTS

Section 513(a)

This section deletes a provision of the Bank Protection Act requiring insured banks and thrift institutions to submit periodic reports with respect to the installation, maintenance, and operation of security devices and procedures.

Section 513(b)

This section makes a ministerial change which gives the agencies more discretion in setting the deadlines for the submission of call reports, by deleting the requirement that call reports must be submitted within 10 days of a "call."

Section 513(c)-(f)

These sections clarify that the banking agencies may assess a civil money penalty for the submission of inaccurate call or bank holding company reports, or call or bank holding company reports that on certain false or misleading information. The penalty for filing such a report, or for filing a late call or bank holding company report, is increased to \$1,000 per day to correspond with the other civil money penalty provisions.

PART B—SAVINGS AND LOANS

SECTION 521. DEFINITION OF "INSTITUTION-RELATED PARTY"

This section amends all references in the Federal Home Loan Bank Board's and FSLIC's enforcement authority that currently

relate to officers, directors, employees and agents, to replace them with the phrase "association-related party" and "institution-related party", as appropriate. These new terms cover a wider range of individuals including a person who has filed or is required to file a notice under the Change in Savings and Loan Control Act.

SECTION 522. CEASE-AND-DESIST ORDERS

This section amends the National Housing Act and Home Owners' Loan Act to address the *Larimore* case. It allows the FHLBB and FSLIC to order restitution or reimbursement from their association-related or institution-related parties to recover losses resulting from violations of law or other improper conduct.

It is the Committee's intent, however, that this power be used only in cases where the institution-related party had unjustly enriched himself at the institution's expense or had acted in reckless disregard of the banking or thrift laws or of prior agency orders. This authority is not to be interpreted as otherwise permitting the agency to use a cease-and-desist proceeding to order an individual to pay damages for losses to the institution. The Committee does not intend that this provision confer unlimited authority on the Federal Home Loan Bank Board or FSLIC to impose money damages without appropriate safeguards.

This section also allows the FHLBB and FSLIC to use a cease-and-desist order to limit the activities or functions of an association-related or institution-related individual or insured institution, thus enabling the FHLBB and FSLIC to prevent specific practices or conduct by thrift officials where the circumstances may not be serious enough to warrant issuance of an order or removal or prohibition under section 407(g).

SECTION 523. SERVICE CORPORATIONS

This section clarifies that the agency's enforcement authority under the National Housing Act and the Home Owners' Loan Act reaches all service corporations, including second-tier and partly owned service corporations.

SECTION 524. TEMPORARY ORDERS

This section clarifies that a temporary cease-and-desist order may place limits on the activities or functions of an association-related party or institution-related party or insured institution, similar to those set out in section 522 above. It also expands the FHLBB's and FSLIC's authority to issue a temporary cease-and-desist order to halt an institution's business activities when the FHLBB and FSLIC is unable to determine the financial condition of such institution or the nature of any transaction because of the disarray or lack of adequate books and records at the institution.

SECTION 525. REMOVAL AND SUSPENSION

This section provides that if an association related party or institution-related party is removed, suspended, or prohibited from an insured institution, service corporation or subsidiary, or a savings and loan holding company or subsidiary, he is also removed, suspended, or prohibited from all federally insured depository institu-

tions, all bank holding companies, and institution chartered under the Farm Credit Act of 1971 (unless he is allowed to return by the appropriate Federal regulatory agency, as defined in the Federal Deposit Insurance Act).

The section also provides that an association related individual may be removed or prohibited based on unsafe or unsound conduct causing financial loss or other damage to an insured institution or another business institution. Furthermore, former paragraph (1), which applied to any director or officer of an insured institution with respect to his conduct regarding *that* institution, and former paragraph (2), which applied to such individual's conduct with respect to *another* insured institution or business entity, have been combined so that paragraph (1) now applies with respect to the individual's conduct regarding *any* insured institution or other business institution. Former paragraph (5) or section 407(g) is revised to use the terms "notice" and "order" consistently throughout the section.

SECTION 526. RETENTION OF JURISDICTION

This section clarifies that FHLBB's and FSLIC's authority to pursue sanctions, including removal, against an association-related or institution-related individual despite his resignation or other separate from an institution. This will prevent such an individual from trying to thwart a removal action by resigning. It also redesignates the paragraph numbers in paragraph (k) of section 407 in order to conform with other changes made in the bill.

This section also provides the FHLBB and FSLIC with the authority to impose monetary penalties for violations of law or regulation.

SECTION 527. PENALTIES

This section makes technical amendments in accordance with changes made in section 525. It also clarifies that only with the prior written approval of the appropriate Federal banking agency may an individual who is the subject of a removal, prohibition or suspension order become an officer or participate in the affairs of another depository institution or holding company. This section would make it clear that the FSLIC or the FHLBB, when issuing a suspension, removal or prohibition order, has authority to prohibit any of the acts that would be illegal under this section.

The second paragraph of this section changes the existing standard of proof for proceedings against individuals (who have been convicted of criminal offenses involving dishonesty or breach of trust and who violate the prohibition against participation in the conduct of the affairs of insured institutions) from a "willful" to a "knowing" violation. It prohibits such individuals from participating in the conduct of the affairs of an insured institution and would increase the penalty from \$100 per day to \$1,000 per day for any violation, which penalty could be imposed against individuals or insured institutions.

SECTION 528. CIVIL PENALTY

This section conforms the FSLIC's civil money penalty authority under the Change in Savings and Loan Control Act (12 U.S.C. § 1730(q)), to the same procedure applicable to other civil money penalty authority of the FSLIC. This means that such penalties may be assessed following a hearing before the agency conducted pursuant to the Administrative Procedure Act instead of the prior requirement for an abbreviated agency procedure, followed by *de novo* review in a U.S. district court.

This section also eliminates the requirement that the FSLIC demonstrate that a violation of the Change in Savings and Loan Control Act is "willful" in order to assess a civil money penalty, thus conforming that Act to other banking law provisions which provide for civil money penalties.

SECTION 529. DEFINITIONS

This section amends the definitions found in section 407(r) of the National Housing Act and section 5 of the Home Owners' Loan Act.

The definition of a "cease-and-desist order that has become final" and "order which has become final" is clarified. The terms "institution-related party" and "association-related party" are defined. The term "insured institution" and "association" is defined for enforcement purposes to include institutions whose insurance has been terminated, an FDIC-insured Federal savings bank and any former Federal savings bank that retains FDIC-insured deposits.

SECTION 530. REPORTS OF CONDITION

This section creates a new paragraph (u) of section 407 of the National Housing Act that requires insured institutions and Federal savings banks to make reports of condition to the FSLIC, and subjects those that either fail to furnish such information or furnish false or misleading information to the assessment of civil penalties. These powers, except for assessment of penalties for submission of false or misleading information for which statutory authority is now being sought, are the same as those already held by the OCC, the FDIC, and the Federal Reserve Board.

SECTION 531. TECHNICAL AMENDMENTS

This section is a technical amendment to conform to the renumbering of certain paragraphs.

SECTION 532. PENALTY FOR FAILURE TO REPORT

This section amends the provisions applicable to savings and loan holding companies to make the requirements for reports of condition parallel to those provided by section 530.

SECTION 533. REPEALER

This section deletes paragraph (15) of section 5(d), which is incorporated into section 5(d)(13) by section 529 of the bill, and redesignates paragraph (16) as paragraph (15).

PART C—CREDIT UNIONS

SECTION 541. AMENDMENTS TO SECTION 206

Section 541(a)

This section replaces the terms officer, director, committee member, employee, agent, or other person with a new phrase—"institution-related party."

Section 541(a)(2)-(3)

This section specifically sets forth various types of relief the NCUA can require as part of a cease-and-desist order, in addition to its current authority to order affirmative action. This amendment explicitly states that the NCUA may place limitations on the activities of individuals or institutions. These modifications would apply to both temporary and final C&D orders.

Section 541(a)(4)

An additional basis for a cease-and-desist order is added for cases in which a credit union's records are so incomplete or inaccurate that the NCUA cannot determine the institution's condition.

Section 541(a)(5)

This section makes the legal standard for removal of individuals the same regardless of whether the objectionable conduct occurred at the current credit union or a previous employer. The standard currently differs based on where the conduct occurred. This amendment differs somewhat from that of the other bank regulatory agencies because the statutory elements for removal/prohibition under the Federal Credit Union Act are different from those of the other agencies. Specifically, the NCUA's statute does not require a showing of personal dishonesty or willful or continuing disregard for the safety or soundness of the credit union. This change maintains that distinction.

Section 541(a)(6)

This section clarifies that the temporary suspension power reaches any institution-related party.

Section 541(a)(7)

This section conforms the Federal Credit Union Act's language regarding the ability of an individual removed or suspended or prohibited from an insured credit union to participate in the affairs of other depository institutions, with the language used in the statutes for the other agencies.

Section 541(a)(8)

This is a technical renumbering provision.

Section 541(a)(9)

This provision declares that termination of employment does not bar an enforcement action.

Section 541(a)(10)

This section adds violation of certain written agreements as an additional basis for assessment of civil money penalties.

Section 541(a)(11)

This section provides a criminal penalty for participating in the affairs of another depository institution if an individual is removed or suspended from a credit union. It also clarifies the NCUA's ability to allow an individual who has been administratively removed to re-enter the industry.

Section 541(a)(12)

This is a technical relettering provision.

Section 541(a)(13)

This section provides definitions for various terms used in the amendments.

This section also explicitly states that the NCUA can use its administrative enforcement power to address a problem regardless of whether it has other statutory authority as well.

SECTION 542. AMENDMENT TO SECTION 502

This change is to section 205 of the Act and provides that if a person convicted of a crime involving dishonesty or breach of trust is employed at an insured institution, and the NCUA has not given its written approval to allow the person to continue, a civil fine of up to \$1,000 a day may be imposed on both the individual and the credit union. The fine is currently only \$100 and it may be assessed only against the credit union.

This section also deletes that requirement that credit unions submit periodic reports concerning security devices and procedures.

TITLE VI—THE TRUTH IN SAVINGS AND INVESTMENT ACT

SECTION 601. SHORT TITLE

This section designates this title as the "Truth in Savings and Investments Act."

SECTION 602. FINDING AND PURPOSE

It is the purpose of this title to require the clear and uniform disclosure of the rates of interest and yields which are payable on accounts and investments and fees which are assessable against such accounts and investments so that consumers can make meaningful comparisons among the competing claims or depository institutions and investment companies.

SECTION 603. DEFINITIONS

This section provides definitions of the terms depository institution, Board account, interest, multiple rate account, and annual percentage yield.

SECTION 604. DISCLOSURE OF YIELDS AND TERMS OF ACCOUNT

A. In General

This subsection provides for the disclosure of the most significant terms and conditions in any advertisement, significant terms and conditions in any advertisement, announcement, or solicitation which includes a reference to a specific rate of interest or a specific yield. Among the terms that would have to be disclosed are the annual percentage yield, the period during which such yield is in effect, all minimum account balances and time requirements, the minimum amount of the initial deposit required to obtain the advertised yield, a statement that regular fees or other conditions could reduce the yield, and a statement of any penalty imposed for early withdrawal.

B. Broadcast and Electronic Media and Outdoor Advertising Exception

This subsection provides for more limited disclosures in the case of broadcast and electronic media and outdoor advertising where the Board finds that certain disclosure would be unnecessarily burdensome.

C. Misleading Description of Free or No Cost Accounts Prohibited

This subsection prohibits the characterization of an account as "free" or "no cost" if in order to avoid fees or service charges (1) a minimum balance must be maintained, (2) the number of transactions during a period is limited, or (3) any regular service or transaction fee is imposed.

D. Misleading or Inaccurate Advertisements, Etc., Prohibited

This subsection prohibits any depository institution from making any advertisement, announcement, or solicitation relating to any deposit account that is inaccurate or misleading or that misrepresents its deposit contracts.

SECTION 605. ACCOUNT SCHEDULE

A. In General

This subsection requires each depository institution to maintain a schedule of fees, charges, yields, and terms and conditions applicable to each class of accounts offered by the depository institution. The schedule for each class may be in the form of separate schedules or one comprehensive document.

B. Information on Fees and Charges

The schedule required under subsection (a) with respect to any account shall contain the following information: a description of all fees, periodic service charges, and penalties which may be charged or assessed against the account or account holder, the amount of any such fees, charges, or penalties (or the method by which such amounts will be calculated), and the conditions under which such amounts will be assessed; all minimum balance requirements that affect fees, charges, and penalties, including a clear description of how each such minimum balance is calculated; and any minimum

amount required with respect to the initial deposit in order to open an account.

C. Information on Yields

The schedule shall also include the following information:

- (1) any annual percentage yield;
- (2) the period during which any such annual percentage yield will be in effect;
- (3) any annual rate of simple interest;
- (4) the frequency with which the interest will be compounded and credited;
- (5) a clear description of the method used to determine the balance on which interest is paid;
- (6) the information described above for any period during which a different interest rate will be in effect;
- (7) any minimum balance which must be maintained to earn the stated rates and yields and a clear description of how the minimum balance is calculated;
- (8) a description of any minimum time requirement which must be met in order to obtain the yields disclosed pursuant to this subsection and any information described in paragraphs (1), (2), (3), or (4) that will apply if any time requirement is not met;
- (9) a statement, if applicable, that any interest which has accrued but has not been credited to an account at a time of a withdrawal from the account will not be paid by the depository institution or credited to the account by reason of such withdrawal; and
- (10) any provision or requirement relating to non-payment of interest, including any charge or penalty for early withdrawal, and the conditions under which any such charge or penalty may be assessed.

D. Other Information

The schedule shall include such other disclosures as the Board may determine to be necessary to allow consumers to understand and compare accounts.

E. Style and Format

Schedules required under subsection (a) shall be written in clear and plain language and be presented in a format designed to allow consumers to readily understand the terms of the accounts offered.

SECTION 606. DISCLOSURE FOR CERTAIN ACCOUNTS

This section provides the Board with the authority to prescribe modifications in the disclosure requirements for accounts with respect to which determination of annual percentage yield is based on annual rate of interest that is guaranteed for a period of less than one year, variable rate accounts, accounts which pursuant to law do not guarantee payment of a stated rate (credit union accounts); and multiple rate accounts.

SECTION 607. DISTRIBUTION OF SCHEDULES

A. In General

This subsection provides that a copy of the schedule shall be mailed to account holders not more than 90 days after the effective date of the initial regulations prescribed by the Board; shall be made available to any person upon request; and shall be provided to any potential customer before an account is opened or service is rendered.

B. Distribution in Case of Certain Initial Deposits

If a depositor is not physically present at an office of a depository institution at the time the initial deposit is accepted, and the schedule has not been furnished previously to such depositor, the depository institution shall mail the schedule to the depositor not later than 10 days after the initial deposit.

C. Distribution of Schedules

This subsection requires a depository institution to provide information to its account holders regarding any change in the terms or conditions which may reduce the yield or otherwise adversely affect the account holder. This information and a description of the change must be mailed at least 30 days before the change takes place.

D. Distribution in the Case of Accounts Established by More Than One Individual or by a Group.

If an account is established by more than one individual or for a person other than the individual, distribution requirements are met if distribution is made to one of the persons who opened the account, or to an individual representative of the person on whose behalf such account was established.

SECTION 608. PAYMENT OF INTEREST

A. Determination of Balance on Which Interest Is Paid

This section requires that interest shall be calculated on the principal balance in an interest-bearing account at a depository institution by using the average daily balance method, which is the sum of each day's closing balance divided by the number of days in the period. The purpose of the subsection is to standardize the basis on which interest is calculated so that consumers can compare the true yields of different accounts. The Committee is particularly concerned about the use of the low balance method, which produces far lower yields than the average daily balance method for the same stated annual rate of simple interest.

B. Special Rule for Credit Unions

Subsection (a) does not apply to credit unions that calculate the accrual of interest or dividends by a method other than the method described in subsection (a) with respect to all funds, including cash, deposited in such account, and provide notice of their interest payment policy to their account holders.

C. Calculated on Full Amount of Principal

This subsection requires that the amount of interest accruing on an interest bearing account shall be calculated on the full amount of the principal in the account for the stated calculation period at the stated rates. The subsection is intended to prohibit use of the "investable balance" method whereby institutions pay interest on less than the full amount on deposit.

D. No Particular Method of Compounding Interest Required

This subsection states that the bill should not be construed as prohibiting or requiring the use of any particular method of compounding or crediting of interest.

SECTION 609. REGULATIONS

A. In General

This subsection requires the Board, within one year after the bill becomes law, to prescribe regulations to carry out the provisions of this title. The regulations which the Board shall prescribe may have any exceptions for any class of accounts which the Board determines to be necessary or proper to carry out the provisions of this title.

B. Model Forms and Clauses

This subsection requires the Board to publish model forms for disclosure to facilitate compliance with this title. A depository institution that uses the model forms would be deemed to be in compliance.

SECTION 610. ADMINISTRATIVE ENFORCEMENT

This section provides for administrative enforcement by the relevant depository institution regulators.

SECTION 611. CIVIL LIABILITY

This section sets forth a penalty structure based on the Truth in Lending Act. In the case of an individual action, liability shall not be less than \$100 nor more than \$1,000. In the case of a class action, the total recovery shall not be more than the lesser of \$500,000 or 1 percent of the net worth of the depository institution involved. Additionally, in any successful action, the court can provide for the payment of the costs of the action together with a reasonable attorney's fee.

SECTION 612. CREDIT UNIONS

A. In General

This subsection exempts credits unions from the regulations prescribed by the Board under this title.

B. Regulations Prescribed by the NCUA

This subsection states that the National Credit Union Administration Board shall promulgate regulations similar to those that the Federal Reserve Board shall prescribe within 90 days of the effective date of the Federal Reserve Board's regulation. These regu-

lations shall take into account the unique nature of the credit unions and the limitations under which they may pay dividends on member accounts. The subsection is intended to give the NCUA the necessary discretion to accommodate the unique needs of credit unions, so long as the regulations are substantially similar to those prescribed by the Federal Reserve Board.

SECTION 613. REVIEW OF DISCLOSURE REQUIREMENTS FOR OPEN-END MANAGEMENT INVESTMENT COMPANIES

This section requires the SEC to consult with the Federal Reserve Board in order to review the regulations prescribed under the Truth in Savings Act and the Securities Act of 1933 and the Investment Company Act of 1940 to determine if such regulations are providing consumers with the ability to compare savings and investment options. This section reflects the fact that the SEC has recently promulgated regulations that should enable consumers to compare different savings and investment products once this bill has been enacted. But if, over time, the Commission determines that its regulations no longer are achieving that purpose, then the Commission shall modify its regulations to meet that goal.

SECTION 614. EFFECT ON STATE LAW

This title supersedes any State laws relating to the disclosure of yields payable or terms for accounts to the extent such State law requires the disclosure of such yields or terms for accounts.

TITLE VII—THE HOME EQUITY LOAN CONSUMER PROTECTION ACT

SECTION 701. SHORT TITLE

This section designates this title as the "Home Equity Loan Consumer Protection Act of 1988."

SECTION 702. DISCLOSURE AND ADVERTISING REQUIREMENTS FOR HOME EQUITY LOANS

Section 702(a) sets forth the required disclosures for home equity loans, open end credit plans secured by the consumer's principal dwelling.

A. Initial Disclosures

1. In general

The initial disclosures shall include:

- (1) a statement that loss of the consumer's home may occur in the event of default;
- (2) a statement of the circumstances under which the consumer or the creditor may terminate the plan, any fees which may be imposed upon termination, and whether the creditor may require payment of the outstanding balance in full at such time;
- (3) the repayment options for the plan, including the length of the repayment period, an explanation of how the minimum monthly or periodic payment will be determined, and an example based on a \$10,000 amount outstanding and a recent inter-

est rate showing the minimum monthly or periodic payment (the recent rate must be a contemporaneous one);

(4) a statement which would inform the consumer if the minimum monthly or periodic payment will reduce the outstanding principal balance;

(5) a statement which tells the consumer if there are any restrictions on the right to draw funds against the line of credit, and any minimum outstanding balance or minimum advance requirements;

(6) a statement regarding any limitations on the tax deductibility of interest;

(7) a statement detailing the creditor's right to require payment in full of any outstanding balance and the consumer's obligation to repay any outstanding balance on a non-amortized basis (balloon payments); and

(8) a statement which discloses if the terms and conditions of the contract are guaranteed and, if not, a statement which details which terms and conditions are not guaranteed.

In addition, the creditor shall make the following disclosures, to the extent the Board determines that the information is not duplicative: a statement of the annual rate of interest when credit is first extended, any conditions which would result in a change in that rate, the annual rate of interest which would be in effect as a result of that change, and an itemization of any fees imposed for the use of the plan, including annual fees, application fees, transaction fees, and closing costs such as points.

2. Variable rate plans

In the case of a plan which is subject to a variable rate of interest, the creditor shall also make the following disclosures:

(1) If applicable, the introductory interest rate and the period of time it will remain in effect;

(2) the formula used in making adjustments, including an identification of the index and margin, if applicable, and a source of information about such index;

(3) a statement that the consumer should ask about the current index value and interest rate;

(4) the frequency of interest rate and payment changes;

(5) any rules relating to changes in the index, interest rate, payment amount and outstanding loan balance, including an explanation of interest rate or payment limitations, negative amortization, and interest rate carryover;

(6) an historical table showing how interest rate and payments under each repayment option of the plan would have been affected by changes in index values during the preceding 15-year period;

(7) a statement of the maximum interest rate and payment amount which could be assessed under the plan, based on a \$10,000 advance;

(8) a statement that interest rate information will be provided on or with the first periodic statement after each rate change;

(9) the maximum amount by which the interest rate may change in any one year period; and

(10) the maximum interest rate that may be imposed at any time under the plan.

B. Time and Form Disclosure

1. Time

(a) *General rule.*—The creditor shall furnish an initial disclosure statement containing the disclosures required by subsection (a) and a brochure, at the time the application form is provided or before the consumer pays or incurs a nonrefundable fee. Section 127 of the Truth in Lending Act continues to govern the timing and form of disclosures required at settlement.

(b) *Mail and telephone applications.*—In the case of mail and telephone applications, the initial disclosure statement shall be provided before the consumer incurs a nonrefundable fee or not later than three business days following receipt of the application, whichever is earlier.

2. Brochure

This section also provides that a brochure be provided to consumers who have entered into a home equity loan. The brochure shall contain information regarding the operation of the home equity product and how to compare among home equity plans and between such plans and closed end credit plans.

3. Form

The form provisions of this section require that general and variable rate disclosures shall be separate from all other disclosures. Additionally, the provision requires that the disclosures about the loss of home in case of default and the creditor's right to terminate the account shall precede all other disclosures.

C. Additional Disclosures for Variable Rate Plans After Interest Rate Adjustment

This subsection states that the creditor shall provide, on or with the first periodic statement after an interest rate adjustment of a variable rate plan, notification of the rate change.

D. Restrictions on Contract Terms

Subsection (d) contains four specific restrictions on permissible contract provisions.

1. No unilateral changes by creditor

This provision prohibits the creditor from making unilateral changes after a contract has been signed. It contains an exception that permits a creditor to change the index unilaterally so long as the interest paid by the consumer, at all times after the change, is no higher than the consumer would have paid under the original index.

2. Use of independent index

This provision requires the lender to use an index that is not within the creditor's immediate control and that is readily available to the public.

3. Terms not guaranteed

This provision requires the creditor to refund to the consumer any money which had been paid to the creditor where the creditor changes the basic terms and conditions between the time of application and the time of the settlement.

4. Grounds for creditor termination of loan

This provision enumerates situations where the creditor has the right to terminate the loan. These include instances in which there is fraud or material misrepresentation on the part of the consumer, failure by the consumer to meet the repayment terms of the agreement for any credit outstanding, and any other action or failure to act by the consumer which adversely affects the creditor's security for the loan.

E. Definitions

1. Principal dwelling

This term has the same meaning as the term "qualified residence" has under section 163(h)(4)(A) of the Internal Revenue Code of 1986. The effect is to require disclosures for any loan that can give rise to interest payments that are tax deductible.

2. Annual rate of simple interest

The annual rate of simple interest means the annual percentage rate, as defined by section 107, determined by subtracting from the amount financed any charges which are not part of the finance charge and any charges which are part of the finance charge but will be paid by the consumer before the transaction.

3. Advertising requirements

Section 702(b) requires additional disclosures in advertisements for home equity loans. Any advertisement that states affirmatively or negatively any specific term of a home equity loan, must also state the following information: any minimum or fixed amount which could be imposed; in a case where periodic rates may be used to compute the finance charge, the periodic rates expressed as an annual rate of interest; any lifetime cap; and any other information which the Board may by regulation require.

SECTION 703. EFFECTIVE DATE

This section states that this title applies to any home equity loan entered into after September 30, 1988.

TITLE VIII—INSURANCE ACTIVITIES

SECTION 801. SHORT TITLE

This section provides a short title for title VIII of the bill.

SECTION 802. AMENDMENTS TO THE BANK HOLDING COMPANY ACT RELATING TO INSURANCE ACTIVITIES

Section 4 of the Bank Holding Company Act generally prohibits bank holding companies from acquiring or retaining the shares of

any company other than a bank or bank holding company. Section 4 also prohibits a bank holding company from engaging in activities other than banking and managing and controlling banks. The major exception to this rule is found in subsection 4(c)(8), which permits a bank holding company to acquire shares of a company engaging in activities that are so closely related to banking or managing or controlling banks as to be a proper incident thereto.

In the Garn-St Germain Depository Institutions Act of 1982, Congress amended section 4(c)(8) to specifically provide that it is not closely related to banking or managing or controlling a bank for a bank holding company to provide insurance as a principal, agent, or broker, unless the insurance is provided under one or more of seven listed exceptions. However, there has been a debate about whether the Garn-St Germain restrictions apply to both bank and nonbank subsidiaries of a bank holding company, or to the nonbank subsidiaries alone. Recently, the Federal Reserve Board issued an order which concluded that the insurance restrictions in section 4(c)(8) do not apply to limit the direct activities of bank holding company bank subsidiaries (unless there is an indication that the acquisition of the bank was primarily for the purpose of evading section 4 of the Bank Holding Company Act). *Merchants National Corporation*, 73 Fed. Res. Bull. 876 (1987). This order was later vacated by the court of appeals on the ground that it violated the moratorium provisions of CEBA. *Independent Insurance Agents of America v. Board of Governors*, 838 F.2d 627 (2d Cir. 1988). However, the underlying issue concerning the applicability of section 4(c)(8) to bank subsidiaries was not resolved by the courts.

Section 802 of the bill addresses this interpretive problem by adding a new subsection (j) to section 4 of the Bank Holding Company Act. This new subsection clearly controls the permissible insurance activities of bank holding companies and their bank and nonbank subsidiaries, including nonbank subsidiaries of the bank.

First, this section defines the terms "insurance" and "insurance activities." It next provides that a bank holding company may not engage in insurance activities in the United States, either directly or through any of its bank or nonbank subsidiaries (including subsidiaries of a bank), unless the insurance activities qualify under one or more of five exemptions. Finally, grandfather rights are accorded to certain companies.

A. Definition of "Insurance" and "Insurance Activities"

The term "insurance" is defined for purposes of sections 4(c)(8), 4(c)(15)(j)(iv) and 4(j) of the Bank Holding Company Act as: (1) traditional insurance products and services; (2) variable annuity contracts; and (3) variable life insurance contracts. "Insurance activities" are defined to include providing insurance as principal, agent or broker. The Committee expects the Board, in determining what are "traditional insurance products and services," to take into consideration State law relating to this issue.

B. Section 4(c)(8) Activities

The first exemption is for insurance activities engaged in pursuant to one or more of the exceptions found in section 4(c)(8) of the Bank Holding Company Act. Under this provision, the insurance

activities must be conducted "pursuant" to section 4(c)(8), which means that the holding company and the entity engaging in the insurance activity must comply with all of the applicable requirements of section 4(c)(8), including the requirement that such activities comply with State law. For example, insurance provided by a finance company subsidiary under section 4(c)(8)(C)(ii) must be credit-related, and the extension of credit must be within the amounts specified in that provision. This section also permits a bank holding company or any subsidiary thereof that has conducted insurance activities pursuant to grandfather rights conferred by section 4(c)(8)(C) (iv) or (vii) to continue to exercise those rights so long as the entity complies with all of the conditions for grandfathering under those sections and carries on its insurance activities within the scope of the rights conferred by those grandfather provisions.

C. State Bank Activities Described in Section 4(c)(8)

The second exemption clarifies that State banks and their subsidiaries may engage in insurance activities which are permissible under section 4(c)(8)(C)(i), (ii), (III), (v), or (vi) of the Bank Holding Company Act, so long as these activities are also authorized under State law.

Under section 4(c)(8)(C)(i), a bank holding company is permitted to engage in credit-related life, disability and unemployment insurance activities. This clarifies that if a State bank or subsidiary is authorized under State law to provide such credit-related insurance, such bank or subsidiary may continue to provide such coverages, notwithstanding any other provision of this bill.

Under section 4(c)(8)(C)(ii), a finance company which is a subsidiary of a bank holding company may also engage in certain credit-related insurance activities. This clarifies that a State bank authorized to have a finance company subsidiary that engages in such credit-related insurance, may continue to engage in such activities, notwithstanding any other provision of this bill.

Under section 4(c)(8)(C)(iii), a bank holding company may provide insurance in a place that has a population not exceeding 5,000 or a place which the holding company can demonstrate has inadequate insurance. This clarifies that to the extent such insurance activities are authorized for a State bank, the bank holding company may also provide insurance in these locations through a State bank subsidiary, notwithstanding any other provision of this bill.

Under section 4(c)(8)(C)(v), a bank holding company may engage in insurance activities which are limited to supervising on behalf of insurance underwriters the activities of retail insurance agents selling certain types of coverage. This clarifies that bank holding companies may engage in this activity through State bank subsidiaries to the extent such activities are authorized for these banks under State law, notwithstanding any other provision of this bill.

Under section 4(c)(8)(C)(vi), a bank holding company with total assets of \$50 million or less may engage in certain insurance agency activities. This clarifies that bank holding companies meeting this asset test may engage in this activity through State bank subsidiaries to the extent such activities are authorized for the bank under State law, notwithstanding any other provision of this bill.

D. State Bank Subsidiary Activities

Under the third exemption, a bank holding company may engage in insurance activities through a State bank (or a subsidiary thereof) if the following conditions are satisfied:

(1) the insurance activities are conducted by a State bank (or subsidiary thereof) located in the bank holding company's "home" State;

(2) the bank or its subsidiary is authorized to engage in such insurance activities by State law; and

(3) the insurance is provided only to residents of that State, natural persons employed in the State, or natural persons otherwise present in the State.

For purposes of this category, a bank holding company's "home" State is to be determined in the same manner as under the Douglas Amendment—section 3(d) of the Bank Holding Company Act. Thus, under this exemption, a bank holding company's "home" State is that State in which the total amount of deposits held by all of the bank subsidiaries of the holding company was largest on May 9, 1956, or on the date the company became a bank holding company, whichever is later. A bank holding company may only have one home State. A bank holding company's home State cannot change, even if at a later date the bank deposits in another State become larger (through acquisitions or otherwise) than the bank deposits in the home State.

Insurance may be provided under this exception only to residents of the home State, natural persons employed in that State, and natural persons otherwise present in that State. A resident includes a natural person and a company, corporation, association, firm, partnership, society, and trust. A resident (other than a natural person) is a resident of a State if it is incorporated in that State or organized under the laws of that State, or has an office in that State, or if it is licensed to do business in that State. For example, a partnership organized under the partnership laws of a New York is a resident of New York, as well as any other State in which it is licensed to do business or has an office. However, a corporate resident may not be used as a conduit to provide insurance to natural persons who are not residents of the State, employed in the State, or otherwise present in the State.

E. National Bank Activities

This exemption permits a bank holding company to engage in insurance activities through a national bank subsidiary (or subsidiary of such bank), to the extent that a free standing national bank may engage in such activities. As will be explained in more detail below, these activities include credit-related life, health and unemployment insurance, insurance in locations with a population of 5,000 or less, and with respect to a particular institution, municipal bond guarantee insurance.

F. Savings Bank Insurance Activities

Under this exemption, the restrictions on insurance activities do not apply to a qualified savings bank which is a subsidiary of a bank holding company and which is engaging in insurance activi-

ties pursuant to section 3(f) of the Bank Holding Company Act. However, such a savings bank must meet all of the requirements of section 3(f). Thus, a savings bank will lose its exemption under this provision if it is acquired by a company that is not a savings bank or savings bank holding company.

G. Grandfather Rights

Section 802 also contains certain grandfather provisions. First, a bank holding company engaging in insurance activities pursuant to the grandfather provision found in the first proviso to section 4(a)(2) of the Bank Holding Company Act may continue to engage in those activities, subject to the requirements and restrictions of that proviso.

Second, section 802 provides that a bank holding company may continue to engage in any insurance activity through a subsidiary State bank (or subsidiary of that bank), if the following conditions are satisfied:

- (1) the State bank was acquired in a State outside of the holding company's home State after December 31, 1984 and before March 2, 1988, pursuant to Board approval under the Douglas Amendment;

- (2) the bank provides insurance only to residents of the State in which the bank is located, natural persons employed in that State, or natural persons otherwise present in that State; and

- (3) the insurance insures against the same types of risks as insurance provided by the bank or subsidiary as of the day before its acquisition or as of March 2, 1988, or against functionally equivalent risks.

Under condition (2), the insurance may only be provided to residents of the State in which the bank is located, natural persons employed in that State, or natural persons otherwise present in that State. This condition is identical to the restriction placed on insurance activities engaged in by State bank subsidiaries located in the same home State as its parent bank holding company.

Under condition (3), the insurance must insure against the same type of risks as insurance provided by the bank or subsidiary as of the day before its acquisition or as of March 2, 1988, or against functionally equivalent risks. The use of the phrase "as of" is intended to mean that the insurance activity did not have to be literally provided on either of the two specified dates in order to be grandfathered. Instead, the insurance activity is subject to the grandfather benefit if it was generally being provided by the institutions in question on either date or immediately leading up to either date. Thus, for example, an institution actually provided term life insurance (as opposed to one merely "authorized" to provide such insurance) leading up to or on the appropriate date may continue to provide such insurance, and functionally equivalent products such as graduated term life, and guaranteed renewable term life, but could not begin offering fire insurance. Similarly, an institution selling only homeowners' insurance could begin selling a new form of homeowners' coverage, but could not begin selling insurance on automobiles or commercial property.

H. Title Insurance

In addition to the exemptions described above, a bank holding company may also provide title insurance coverage through a State bank or subsidiary thereof if the bank was required to be empowered to provide title insurance as a condition of its initial chartering under State law. A change in State law after the bank was chartered altering this requirement does not affect the privilege granted under this provision.

I. Transfer of Existing 4(c)(8)(C)(iv) Exemption

Section 4(c)(8)(C)(iv) of the Bank Holding Company Act is a grandfather provision which permits bank holding companies to continue to engage in certain insurance activities which were engaged in by the bank holding company or any of its subsidiaries on May 1, 1982. In several recent decisions, the Federal Reserve Board concluded that a company enjoying grandfather privileges under this exemption could be acquired by another company, without losing these privileges. See e.g., *Trustcorp, Inc.*, 73 Fed. Res. Bull. 934 (1987). However, the propriety of these orders is currently subject to litigation in the courts.

Section 802 amends section 4(c)(8)(C)(iv) to provide that the grandfather benefits contained therein are terminated if a grandfathered company is acquired by another company on or after March 2, 1988. The grandfather rights also terminate if the insurance activities are transferred to any other company, subsidiary or affiliate of the bank holding company after March 2, 1988. This restriction does not apply to corporate reorganizations in which the new bank holding company is a "successor" as that term is defined in section 2(e) of the Bank Holding Company Act. Further, the acquisition of the entity engaging in insurance activities under section 4(c)(8)(C)(iv) by a bank holding company will not result in a termination of section 4(c)(8)(C)(iv) grandfather rights, if the total assets of the new entity are at the time of acquisition, and thereafter, no more than \$50 million.

In applying the \$50 million restriction, the Board is expected to take into account that many smaller bank holding companies may not have complete and accurate financial figures until the holding company prepares its quarterly report. It is not the intent of this provision to require a bank holding company to cease its insurance activities under this provision simply because it inadvertently exceeded the \$50 million requirement due to the constraints of its financial recordkeeping system, so long as the Board determines that it is not the intent of the company to grow beyond the \$50 million level. However, the Committee expects the Board to require such a company to reduce its assets to the \$50 million level by a date certain.

The inclusion of this provision restricting the transferability of section 4(c)(8)(C)(iv) grandfather rights is also not intended to affect in any manner the legal status of the transfer of these rights which were completed prior to March 2, 1988. This legislation does not affect any litigation currently pending regarding Board orders permitting the transfer of grandfather rights under this subparagraph.

In addition, this title is not intended to affect the transferability of grandfather rights under section 4(c)(8)(C)(vii) of the Bank Holding Company Act, or any other provision of law. It is not the intent of the Committee to affect in any manner any litigation, now pending or which may arise in the future, regarding the permissibility of the transfer of such rights, other than under section 4(c)(8)(C)(iv).

SECTION 803. AMENDMENTS TO THE NATIONAL BANK ACT

Under the National Bank Act, a national bank may engage in insurance activities which are incidental to its business as a national bank. Section 803 amends the National Bank Act to specifically provide that a national bank, or subsidiary thereof, may only engage in insurance activities in the United States which are limited to assuring the repayment of the outstanding balance due on a specific extension of credit by the national bank in the event of the death, disability or involuntary unemployment of the debtor. Thus this section prohibits national banks from providing title insurance as principal agent or broker.

In addition to credit-related insurance, the National Bank Act also currently permits a national bank to engage in *any* type of insurance agency activity in a place with a population of 5,000 or less, so long as the bank is located in that place. Section 803 amends this provision to provide that a national bank located in such a place may sell insurance in that place so long as : (1) such insurance activities are confined to that place, and (2) the insurance is sold only to residents of the State in which the association is located and natural persons employed in that State.

A national bank is located in a place if it has a branch or lending office in that place. It does not have to be headquartered in that location. A national bank meeting this requirement is thus authorized to sell insurance in the town in which it is located. However, the insurance could not be sold nationwide. Rather, the insurance activities must be directed towards the people or businesses located in that place and its immediate environs.

In addition to limiting the insurance activity to places with a population of 5,000 or less, the bill also requires that the insurance only be sold to residents of the State in which the national bank is located, and to persons employed in that State. A company, corporation, association, firm, partnership, society, or trust is a "resident" of a State if it (1) is incorporated in that State; (2) is organized under the laws of that State; (3) has an office in that State; or (4) is licensed to do business in that State.

The terms "insurance" and "insurance activities" are defined to have the same meaning given those terms under section 802 of this bill with respect to bank holding companies.

Section 803 also exempts from these restrictions municipal bond guarantee insurance activities that were approved for national bank by the Comptroller of the Currency on or before May 2, 1985. A national bank which received this approval may continue to engage in municipal bond guarantee insurance activities, notwithstanding the restrictions in section 803. However, this grandfather provision is not intended to affect any litigation regarding the propriety of the Comptroller's action in this matter.

SECTION 804. EFFECTIVE DATE

Section 804 provides that title VIII shall take effect on March 5, 1987. This is the date that the CEBA moratorium on additional insurance activities for bank holding companies first went into effect.

TITLE IX—MISCELLANEOUS

SECTION 901. STUDY OF HOSTILE ACQUISITIONS OF UNITED STATES BANKS

Hostile acquisitions in the banking industry have been very rare, but recent events have raised the possibility that they could become more common.

This section requires the Federal Reserve Board, in consultation with the Attorney General, the Comptroller General, and the Federal Deposit Insurance Corporation, to prepare a study of the effects that hostile acquisitions in the banking industry could have on U.S. banking and financial markets. The Board and the other Government agencies involved must hold a public hearing on this issue. Not later than 90 days after the bill becomes law, the Board must transmit a report containing the results of this study, to this Committee and to the Committee on Banking, Finance and Urban Affairs of the House of Representatives.

Neither the study nor the report is intended to influence any transaction that is currently pending, including any transaction for which an application is pending before the Board or for which the Board has already granted approval or conditional approval. The Committee is simply requesting more information on the public policy concerns raised by hostile acquisitions.

SECTION 902. LIMITATIONS ON GRANDFATHERED NONBANK BANKS OWNED BY BANK HOLDING COMPANIES

Under the Competitive Equality Banking Act ("CEBA"), a trust company engaged solely in trust and fiduciary activities is exempt from the definition of a "bank" under the Bank Holding Company Act if it complies with certain restrictions. 12 U.S.C. § 1841(c)(2)(D). For example, such a company may not make commercial loans or accept demand deposits or transaction accounts.

CEBA also permits a bank holding company to retain any nonbank bank that it controlled on August 10, 1987—the date on which CEBA became law—so long as the nonbank bank does not (1) increase the number of offices from which it does business, or (2) both accept demand deposits and make commercial loans. However, there are no other activity or growth limitations on the nonbank bank.

Recently, several bank holding companies that controlled trust companies on August 10, 1987, have converted those institutions into grandfather nonbank banks, thus permitting those institutions—which were chartered to provide trust services—into banks capable of providing a wide range of banking services.

Section 902 of the bill prevents this unintended result by prohibiting a nonbank bank controlled by a bank holding company on August 10, 1987, from making commercial loans or accepting demand deposits or transaction accounts, unless the Federal Re-

serve Board authorized the nonbank bank to engage in that activity as of that date—the date on which CEBA became law.

SECTION 903. JOINT MARKETING RESTRICTIONS

Under CEBA, a company controlling a grandfathered nonbank is restricted in its ability to jointly market the products and services of the nonbank bank with an affiliated company engaging in activities not permitted under section 4(c)(8) of the Bank Holding Company Act. In addition, the nonbank bank may not market the products and services offered by an affiliated company that are not permissible under section 4(c)(8).

This section makes two changes in this restriction. First, it authorizes joint marketing with a nonbanking affiliate which is engaged in products or services that are permissible under section 4(c)(15) as well as 4(c)(8). Second, rather than applying the joint marketing limitation to all of the activities of a nonbanking affiliate which is engaging in some impermissible activities, this provision amends CEBA to permit a nonbanking affiliate to jointly market the nonbank bank's products and services with those products and services offered by the nonbanking affiliate which are permissible activities under section 4(c)(8) or 4(c)(15). For example, an affiliate engaging in impermissible insurance activities could not market both its insurance and its nonbank bank's insured deposits, but that same affiliate could market its credit-related insurance (permissible under section 4(c)(8)) and the affiliated bank's mortgage loans.

SECTION 904. INDUSTRIAL BANKS

A. Clerical Amendment

In revising the Bank Holding Company's Act's definition of a "bank", the Competitive Equality Banking Act of 1987 repeatedly referred to accepting "demand deposits or deposits that the depositor may withdraw by check or similar means for payment to third parties." 12 U.S.C. § 1841 (c)(1)(B)(i) (definition of "bank"), (c)(2)(D)(iii) (trust company exemption), (c)(2)(F)(ii) (credit card bank exemption). However, in the parallel provision dealing with industrial banks, industrial loan companies, and similar institutions, the words "or deposits" after "demand deposits" were omitted through a clerical error. 12 U.S.C. § 1841(c)(2)(H)(i)(I).

Section 904(a) of the bill corrects that error.

B. Activities Authorized as of March 5, 1987

Section 904(b) amends the provision of CEBA authorizing an exemption from the definition of the term "bank" under the Bank Holding Company Act for industrial banks, which meet certain conditions. One of these conditions is that the industrial bank, in certain cases, not engage in activities it was not lawfully engaged in on March 5, 1987. This section of the bill amends that restriction to permit an industrial bank to continue to engage in activities it was either lawfully engaged in on that date, or activities it was authorized to engage in on that date.

SECTION 905. STATUS OF CERTAIN REGISTERED INVESTMENT COMPANY

The Connecticut Liquidity Investment Fund was incorporated on March 29, 1985, but through inadvertence did not register with the SEC as an investment company until February 21, 1986. Although the Fund was not required to register under the Investment Company Act because it had less than 100 shareholders, registration does have tax consequences. Under this section, the Fund would be deemed to have been registered under the Investment Company Act as of March 29, 1985.

REGULATORY IMPACT STATEMENT

Pursuant to Rule XXVI, paragraph 11(b) of the Standing Rules of the Senate, the Committee has evaluated the regulatory impact of the bill and concludes it would result in no net increase in the regulatory burden imposed by the Government. In fact, the provisions of Title II will streamline procedures for forming bank holding companies and also for engaging in new nonbanking activities under the framework of such a holding company. That Title will also allow banking regulators to more expeditiously process applications for bank acquisitions and mergers. These amendments should reduce paperwork and the costs to persons subject to these provisions of law.

CHANGES IN EXISTING LAW

The Committee has determined that it is necessary, in order to expedite the business of the Senate, to dispense with the requirements of Rule XXVI, paragraph 12, of the Standing Rules of the Senate, with respect to this legislation.

COST OF LEGISLATION

The Committee has requested a cost estimate of this legislation under the provisions of Section 403 of the Congressional Budget Act of 1974. The cost estimate of the Congressional Budget Office appears below:

U.S. CONGRESS,
CONGRESSIONAL BUDGET OFFICE,
Washington, DC, March 22, 1988.

Hon. WILLIAM PROXMIRE,
Chairman, Committee on Banking, Housing, and Urban Affairs,
U.S. Senate, Washington, DC.

DEAR MR. CHAIRMAN: The Congressional Budget Office has reviewed S. 1886, the Financial Modernization Act of 1988, as ordered reported by the Senate Committee on Banking, Housing, and Urban Affairs on March 2, 1988. We expect that enactment of this bill would cost the federal government \$5 million in 1989, and about \$6 million annually through 1993, assuming appropriation of the necessary amounts.

This bill would repeal provisions of the Glass-Steagall Act that bar affiliations between banks and securities firms. It would place the new securities activities of bank holding companies under the regulation of the Securities and Exchange Commission (SEC).

Based on information from the SEC, we expect that the costs to regulate and monitor market securities activities, as well as to conduct studies and prepare reports, would be approximately \$3 million in 1989, increasing to \$4.5 million by 1993, assuming the necessary appropriations. In addition, assuming enactment by July, 1988, it is possible that the SEC would request a supplemental appropriation of around \$500,000 in 1988 to begin carrying out these responsibilities.

Title VI of S. 1886 would require depository institutions to display standardized information in advertisements for depository instruments. Title VII would specify the information that must be provided to applicants for home equity loans; it also places certain restrictions on contract terms. The bill would require the Board of Governors of the Federal Reserve to issue regulations and to ensure compliance with these provisions. In addition, the Federal Reserve would be required to enforce the provisions of the Bank Holding Company Act as it affects the safety and soundness of banking institutions.

Based on information from the Federal Reserve, we estimate that additional costs for examination, supervision, training and other administrative requirements would be approximately \$2 million annually through 1993. Costs in 1988 are not expected to be significant. Because the Federal Reserve remits each year's surplus to the Treasury as a revenue, any additional operating costs would reduce revenues on the budget and would not require appropriation action.

S. 1886 would also require enforcement activities by other bank regulatory agencies, including the Comptroller of the Currency, the Federal Deposit Insurance Corporation, the Federal Home Loan Bank Board, and the National Credit Union Administration. Based on information from these agencies, we expect that enactment of S. 1886 would have no significant affect on their administrative budgets, which are largely funded by assessments. In fact, the additional enforcement authority provided in Title V could reduce future insurance losses, which would have the effect of reducing federal outlays, although we have no way of predicting with any certainty whether or not that would occur.

No significant costs would be incurred by state or local governments as a result of this bill.

If you wish further details on this estimate, we would be pleased to provide them.

Sincerely,

JAMES L. BLUM
(Acting Director)

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ADDITIONAL VIEWS OF SENATORS PROXMIRE, SANFORD,
GRAHAM, GARN, HECHT, BOND, AND ARMSTRONG

The bill reported by the Committee permits State banks to continue to engage in State authorized insurance activities, but only if the bank is either a free-standing bank or owned by an in-State bank holding company. If the State bank is owned or acquired by an out-of-State bank holding company, it must divest its insurance activities even if they are limited to the State in which the bank is located. Thus, a State bank could not engage in authorized, in-State insurance activities if acquired by an out-of-State holding company, even if the State where the bank is located passed a new law to specifically permit such banks to engage in these activities. This is an unnecessary preemption of State authority.

There are three key issues relating to the insurance section of the bill:

1. *State Autonomy.* The current State-by-State differences in the regulation of insurance activities are based on local economic, political, and social influences and reflect the judgment of the legislators in each State. The autonomy is important. The respect for each State's right to determine what is in its own best interest should not be undermined by Federal-mandated requirements that banks divest activities that State authority permits.

2. *Douglasizing Provision.* the traditional state jurisdiction over insurance laws within its own border has served the nation well. The success of State regulation is recognized and supported by the elimination in this bill of the South Dakota loophole and the Comptroller's 5,000 population loophole.

The general purpose of the Committee provision is to prevent the interstate expansion of insurance activities of bank holding companies through the acquisition of out-of-State banks, but it should not override explicit State laws to the contrary. Like interstate bank expansion under the Douglas amendment to the Bank Holding Company Act, interstate bank insurance expansion should be prohibited unless a State expressly permits it by an explicit State statute.

Such a "Douglasizing" of the insurance provision makes sense because States that now permit bank insurance activities may not have passed their laws with full consideration given to the possibility of bank acquisitions by out-of-State holding companies. The State's right to regulate insurance laws can be accommodated in Federal banking legislation if we provide that an out-of-State bank holding company may acquire a State bank, and engage in insurance activities through that bank, only under two conditions:

a) That the State in which the bank is located expressly provides by statute that its banks may be acquired by an out-of-State holding company; and

b) That the State in which such an acquired bank is located provides by statute that such banks may engage in insurance activities within that State.

No State currently has such a statute on its books and therefore a State would have to take positive action to authorize this type of acquisition. Further, since the insurance activities would be limited to the authorizing State, there would be no opportunity to abuse the privilege by extending it nationwide.

Such a provision would be consistent by reinforcing principles of State authority and would not alter the committee's basic decision to close the "South Dakota" loophole and the Comptroller's 5,000 population loophole but would make the bill consistent with the actions the Committee has already taken. The authority for insurance regulation would remain completely with the State.

3. *Regional Banking Developments.* The movement toward regional banking agreements is healthy and energetic and should be encouraged, not restricted. It is neither our function nor our intention to in any way inhibit the natural progress of the emerging regional bank movement. The needs and the circumstances peculiar to each region of the country are best served by a system sensitive to those differences and to the opportunities for growth and success. Natural financial markets are developing along these lines, and will continue to develop in the future. These regional relationships have been a product of innovative changes orchestrated by the States, based on decisions regarding the economic needs of the citizens of those States.

Avoiding heavy-handed federal restrictions offers the greatest chance for these positive developments to continue and for States to continue to meet the needs of consumers. The effect of the current provisions on regional banking in the bill would not allow States to approve insurance activities for their out-of-State bank holding companies.

Members of the Committee have agreed to reconsider this issue before floor action to see if it is possible to agree on an amendment to preserve the right of the States to authorize insurance activities within their borders by an out-of-State bank holding company. We encourage these discussions and hope that an agreed upon amendment can be developed to remove the bill's restrictions on the States in this area.

WILLIAM PROXMIRE.
TERRY SANFORD.
BOB GRAHAM.
JAKE GARN.
CHIC HECHT.
KIT BOND.
WILLIAM ARMSTRONG.

ADDITIONAL VIEWS OF SENATORS DIXON, SANFORD, AND GARN

The Glass-Steagall Act was signed into law in 1933. It has remained unchanged since then, but the rest of the world has not. Much of the basic structure of our financial services law was put in place during the Depression. It is now badly out of step with the needs of the 1980's and beyond.

A revolution has occurred in the financial industry since the 1930's. The participants currently operate in a framework which forces them to spend valuable time, effort, and resources figuring out ways to get around outdated and outmoded laws. The neat, compartmentalized financial services system Congress set up is bursting at the seams, as securities firms move into insurance, real estate and banking, and other financial sectors attempt similar actions to broaden the range of products and services they offer.

Three revolutions require explanation to understand the framework within which Congress must act; an information revolution, the securitization revolution and the internationalization of the financial services industry.

First, a fundamental change has occurred in the exchange of information. Banks and other financial intermediaries are basically in the information business. Banks bring together depositors and borrowers because they have the information to judge the risks; their information advantage has made them essential and has helped ensure their profitability.

Because of the communications and computer revolutions, however, the cost of recording, transmitting, and processing information has fallen by over 95 percent since 1964, according to bank sources. Of course, this means banks have lower costs, but it also means it is possible to make information cheaply available to many more people, making it possible for users and providers of credit to get together without using banks.

These changes helped make a second major revolution possible, the "securitization" revolution. "Securitization" refers to two very important trends—the increasing use of securities products instead of bank products to meet customer's financial services needs, and the conversion of loans into securities.

A few figures illustrate the importance of the changes underway. The domestic commercial paper market, for example, has more than doubled to about \$350 billion in size in the last 5 years. It grew by roughly 140 percent from 1980 to 1985, while bank commercial and industrial loans were growing by only about 50 percent.

The amount of asset-backed securities outstanding—securities backed by instruments such as mortgages, car loans, and credit card receivables—grew from \$25 billion in 1980 to \$270 billion in 1986. Mortgage-backed securities accounted for roughly 5 percent of

mortgage originations in 1975; they now account for over 25 percent.

"Securitization" has taken place in areas besides lending. Mutual funds have grown by leaps and bounds. By 1983, mutual fund assets roughly equalled the amount in bank checking accounts.

The increasing "securitization" of financial markets in major financial centers around the world leads to the third revolution—the "Internationalization" of financial markets. Even medium-sized U.S. commercial firms increasingly consider the Eurobond, Euro-commercial paper, and Euroequities markets to meet their capital needs. These international markets are growing rapidly. The Eurobond market grew by over 800 percent in the 1980-86 period, for example, and major foreign capital markets continue making their marketplace more competitive with the United States. The "Big Bang" in London and the enactment of comprehensive financial reform legislation in Canada are simply the most recent dramatic examples of this trend.

Moreover, foreign banks and other financial firms play an ever-growing role in our domestic markets. Foreign banks now hold, for example, over 18 percent of the \$2.3 trillion in total U.S. bank deposits. They now hold 22 percent of all U.S. commercial and industrial loans, up from less than 8 percent in 1973.

Because of these three revolutions—and many other changes, like the deregulation of interest rates—the role of the banking system is fundamentally changing, and to be successful, banks must adapt to the changes. At least partially because of regulatory restraints, however, banks have had great difficulty in meeting the new competitive challenges.

Banks had 47 percent of total domestic financial assets in 1953; they now have only about 31 percent. Banks accounted for 87 percent of short- and medium-term credit in the fifties; now their share is less than 55 percent. Since 1978, the banks' share of short-term credit for commercial or industrial companies with over \$1 million in assets has dropped in half, from roughly 50 percent to only 25 percent.

Unfortunately, Congress was rather slow to react to the financial services revolutions. Since 1981, the Senate Banking Committee has held 83 days of hearings on banking reform issues. The Committee heard from at least 457 witnesses, and accumulated over 18,000 pages of testimony and exhibits.

Congress debated banking reform, analyzed it, considered it, chewed on it, and thought about it. It did everything it was possible to do with banking reform except the one thing that really mattered—act on legislation that actually addressed the issues.

This bill begins the process of changing that situation. This compromise proposal does not address all of the outstanding reform issues; there is not yet any consensus on what a comprehensive reform bill should look like. However, it does take a significant first step in an area where there is broad agreement in the Senate—the Glass-Steagall separation between investment and commercial banking.

In one sense, this is truly landmark legislation. However, a closer look at the background of Glass-Steagall and at the securi-

ties activities banks currently engage in makes it clear that the Committee bill is actually rather moderate.

The Glass-Steagall Act was based on the assumption that commercial banks' securities activities were in no small part responsible for the stock market crash and the collapse of the banking system. Additionally, Senator Glass believed there were real problems associated with the relationship between commercial banks and their securities affiliates and that banks had been involved in objectionable practices in the marketing of securities.

Senator Glass, however, may have greatly overestimated the problems created by the rise of bank securities activities in the 1920's. While there were almost 2300 bank failures in 1931 alone, and another 4,000 failures in 1933, these failures were almost all undercapitalized rural banks. They had little or nothing to do with bank securities activities.

As Senator Glass himself said: "Only 37 banks, or four-tenths of 1 percent [of the total bank failures during the Depression] had a capital of as much as \$1,000,000 . . . 90 percent [of bank failures] occurred in towns and cities with a population of less than 25,000."

A recent study by the staff of the Federal Deposit Insurance Corporation and a review undertaken by the President's Council of Economic Advisors confirms this analysis. They did not find any large bank failures attributable to the marketing or underwriting activities of bank securities affiliates, with the exception of the Bank of the United States where the problem was cut and out fraud.

This is not to say that there were not problems with bank securities activities. The truth, however, seems to be that any problems were not unique to banks, but were shared by the entire securities industry, and were thus appropriately addressed by the Securities Act of 1933 and the Securities Exchange Act of 1934.

There was a real crisis of confidence in the banking system in the 1930's, but the creation of the Federal Deposit Insurance Corporation had much more to do with restoring confidence than Glass-Steagall did.

Even Senator Glass seemed to question whether complete separation of banking and securities activities was really essential. In 1935, he supported legislation that passed the Senate permitting banks to underwrite corporate debt securities.

The need for a fundamental reexamination of Glass-Steagall is not simply based on a judgment that its underlying assumptions were flawed. It is also required because Glass-Steagall no longer works and because, in reality, Glass-Steagall never fully separated commercial and investment banking. The degree of separation it did impose has been substantially undermined over the years. In one securities area after another, there is evidence of increased bank activity.

Glass-Steagall permitted banks to continue underwriting general obligation municipal bonds. In the 1930's this was the bulk of the municipal market, but that has changed. Revenue bonds now account for over half of the \$720 billion in municipal bonds outstanding.

Banks were originally excluded from the revenue bond market altogether, but the law now permits banks to underwrite some

kinds of revenue bonds, including housing and university bonds. Further, banks can be involved in revenue bonds backed by bank letters of credit, and they can engage in private placement activities.

Glass-Steagall excludes banks from the commercial paper markets, but there too, the barriers have fallen. Banks privately place commercial paper, they have some powers related to commercial paper backed by a bank letter of credit, and they can underwrite and deal in Euro-commercial paper. The size of the Euro-commercial paper market has grown dramatically since 1984. Euro-commercial paper outstanding rose from \$3 billion in 1984 to \$50 billion in 1986.

Barriers have also fallen in the mortgage-backed securities market. Even though banks originate many of the mortgages that are packaged into securities, they cannot underwrite or deal in certain of the securities themselves. However, as a practical matter, banks can participate to some extent, but not completely, in the \$1.5 trillion mortgage-backed securities market.

Banks currently cannot engage in underwriting and dealing in corporate debt securities in the United States. However, banks do a major business in privately placing corporate debt instruments with institutional customers. This may seem like a narrow activity, but \$278 billion worth of debt was placed this way in 1986. Further, banks can and do underwrite corporate bonds overseas. U.S. banks fully participate in the Eurobond market, for example, a market that has grown from \$39 billion in 1980 to \$225 billion in 1986.

It is important to remember that while the market may be overseas, the issuers are increasingly American firms, and not just our largest corporations. Because of the limits placed on them in the U.S. market, our banks increasingly take their customers abroad to meet their credit needs.

In the mutual fund area, banks can provide back office services, investment advisors, custodial and transfer agent services, and shareholder recordkeeping and other administrative services. Through their trust powers, banks can co-mingle IRA accounts and invest them like mutual funds.

In addition to IRA powers, banks have participated in other investment activities through their trust departments since the enactment of Glass-Steagall. Section 16 of the Glass-Steagall act has always permitted banks through their trust departments or otherwise to act as a broker or agent in arranging for the purchase or sale of all types of securities on behalf of customers. This includes, without limitation, debt and equity securities, interests in mutual funds and mortgage and other receivable-backed securities.

These are only some of the securities activities banks can engage in. In Europe, banks can even engage in underwriting of corporate equities, although limited by regulation K. In this country, banks have been providing discount brokerage services.

While banks have had to struggle to meet their customers needs by expanding their securities activities, the savings and loan industry has had the benefit of explicit statutory authority. In fact, unitary savings and loan holding companies can engage in a much broader range of services than can a comparable bank holding company. Even if two or more savings and loans form a holding compa-

ny known as a "multiple thrift holding company" their scope of permissible activities still remains broader than that currently granted to a bank holding company. Examples of this include the areas of insurance, full-service stock brokerage and real estate activities. Almost any company, including a securities company, that wants to get into banking without being subject to the kind of restrictive regulations that apply to banks can do so by buying a thrift. That means that insured deposit accounts and securities products can already be linked, even if the company does not own a nonbank bank.

The Glass-Steagall barrier, therefore, is increasingly fractured and even without Congressional action, will likely soon shatter completely. Whether it ever created a real separation between banking and securities activities no longer matters, because banks do participate in a wide and growing variety of securities activities. One major money center bank holding company attributed fully one-third of its 1986 earnings to securities activities.

The Financial Modernization Act recognizes these facts, and creates a more sensible system for banks to operate under, a system that helps reduce risks to the banking system. As the Committee report points out at some length, the heart of the approach taken by the bill is to require that most additional securities activities be exercised only in an affiliate of the bank holding company that is fully separated from the bank. The bill permits banks, in the bank, to underwrite revenue bonds and to sell mutual funds (this is designed to help small banks that can't afford to set up a separate securities affiliate of a holding company). If a bank wants to exercise any other new powers, it must set up a securities affiliate (and the mutual fund activities must be conducted out of that affiliate).

The affiliate will have authority to engage in mortgage-backed securities, commercial paper, and other asset-backed securities, such as bonds secured by credit card receivables or automobile loans. After 6 months, the securities affiliate will be able to underwrite and deal in mutual funds and corporate debt. Underwriting and dealing in equity securities is prohibited unless Congress, in 1991 under expedited procedures, affirmatively votes to provide affiliates with this authority.

This phase-in of securities powers is another demonstration that the Committee has taken a prudent and conservative approach to the Glass-Steagall issue. It proves that the Committee has seriously considered events like the October, 1987, stock market crash, and that all necessary actions to protect banks from undue risks have been taken.

The bill contains a number of new provisions designed to ensure that securities activities conducted by banking organizations are conducted safely, soundly, and in a pro-competitive manner. Under the bill, a bank or thrift affiliated with a securities affiliate may not:

- (1) make loans or otherwise extend credit to the securities affiliate;
- (2) purchase for its own account financial assets of the securities affiliate;
- (3) issue a guarantee or letter of credit for the benefit of the securities affiliate;

(4) take actions to enhance the marketability of securities underwritten or distributed by the securities affiliate (say, for example, by loaning the company issuing securities money on concessionary terms);

(5) extend credit to an investment company client of the securities affiliate;

(6) extend credit to an issuer of securities for the purpose of repaying principal or interest on securities underwritten or distributed by the securities affiliate;

(7) express an opinion on the value or advisability of purchasing or selling shares underwritten or dealt in by the securities affiliate;

(8) disclose to the securities affiliate nonpublic customer information without the consent of the customer; or

(9) purchase, for its own account or as a fiduciary, securities underwritten by a securities affiliate during the underwriting period and for 30 days thereafter.

These restrictions help ensure that the competition between securities affiliates owned by bank holding companies and other securities firms is fair and equitable, and that the bank is protected from any additional risks attributable to securities activities. However the bill does not stop here:

(10) In addition, neither a bank holding company, its affiliated banks, or any other affiliate may make loans or otherwise extend credit to a customer of a securities affiliate to purchase securities underwritten by that securities affiliate during the underwriting period and for 30 days thereafter;

(11) a securities affiliate may not underwrite or distribute securities backed by assets originated by an affiliated bank or thrift unless those securities are independently rated;

(12) the securities affiliate must prominently disclose that the securities affiliate is not a bank or thrift, and that its customers are not insured by the FDIC or FSLIC; and

(13) a bank or thrift may not have interlocking officers or directors with the securities affiliate unless approved by the Fed, or unless the bank holding company has total banking assets of less than \$500 million.

To further protect bank capital from securities risks, the bill:

(14) prohibits any bank holding company with assets of \$30 billion or more from affiliating with an investment banking company with assets of \$15 billion or more. This essentially prevents any of the top U.S. 15 banks from buying any of the top 15 U.S. securities firms. This also includes foreign banks and foreign investment banking firms if the resulting company will have both a banking and securities operation in the U.S.;

(15) prevents a bank holding company from acquiring a securities affiliate if it would reduce the bank holding company's capital below the minimum required level;

(16) requires, for purposes of determining bank holding company capital, that equity investments the holding company makes in the securities affiliate cannot be counted (so, for example, if a bank holding company starts a securities affiliate and capitalizes it with \$100 million, the \$100 million in stock of the securities affiliate held by the holding company cannot

be counted as holding company capital, even though it is technically an asset);

(17) requires the Federal Reserve Board to approve each bank holding company equity investment in its securities affiliate; and

(18) prohibits a securities affiliate from underwriting corporate debt or equity (if the securities affiliate receives that authority in 1991) if any affiliated bank is below its required risk-based capital level. The Federal Reserve Board has issued new guidelines, which will force banks to increase their capital to 8 percent—of which 4 percent must be common shareholders equity and only 1.25 percent of which can be loan loss reserve—by 1992).

These 18 provisions are in addition to the anti-tying provisions, the capital provisions, and the provisions regulating transactions between a bank and other parts of the holding company that are already part of the Bank Holding Company Act. They are designed to generally replace ad hoc system under which banks and bank holding companies conduct their securities activities. They make it more efficient and cost-effective for banks to conduct these activities, while ensuring a level competitive playing field among all those in the securities business, and while providing a much greater degree of protection for the banking system than the law currently provides.

The bill goes to some lengths to protect banks from any risks due to the affiliate's securities activities, even though securities may not create major additional risks for bank holding companies. As Congress considers the risk issue, it is worth noting that basic banking activities are increasingly risky as the better customers leave the banks for other providers of financial services better able to meet their needs.

Greater risk evidences itself in a variety of ways. One measure is that even though we are in the sixth year of recovery, there could be 200 bank failure this year, the highest number since the Great Depression. Another is that banks had to set aside only about 17 percent of their net operating income in 1979 to cover loan losses, while last year the set aside rose to 49 percent.

While basic bank lending activities seem to becoming more risky, there is evidence that securities risks can be effectively managed. It is worth noting, for example, that the annual after-tax rates of return on equity capital for investment banks between 1979 and 1983, a period that included a major recession, was nearly twice that of the ten largest bank holding companies.

Underwriting and dealing in corporate securities presents risk. However, the risk is the same kind as underwriting and dealing in U.S. Government, municipal, and Euromarket securities in which banks already engage. Unlike other risks banks engage in, risks in underwriting and dealing in corporate securities are assumed for very short periods of time and the assets involved are highly liquid.

Nonetheless, the bill chooses to err on the side of caution in the degree of insulation it provides between banking and securities activities, in order to ensure that there is no doubt that banks are protected from significant new risks. Importantly, the bill is able to accomplish this objective while still providing the kind of competi-

tion-based restructuring that the financial services marketplace has clearly demanded.

The regulators and the courts have taken a number of actions over the years that have tended to erode the Glass-Steagall barrier. They have acted not because they are eager to undermine a 1933 statute, but because changes in the marketplace demand and require action. The Financial Modernization Act is a necessary and long overdue substitute for the kind of loophole creation and exploitation that Congressional inaction has caused. It replaces reform by loophole with clear Congressional policy that is responsive to the changed conditions we are facing today. The bill does not tear down the barrier between investment and commercial banking. Instead, it recognizes that marketplace changes have already eroded the separation and make maintaining it impossible. It does nothing more, and nothing less, than manage the changes that have occurred and which continue to occur in a way that maximizes competitive opportunities and minimizes risks. It is landmark legislation, but, at the same time, it is moderate, prudent legislation. It is long overdue and it should be quickly enacted.

ALAN J. DIXON.

TERRY SANFORD.

JAKE GARN.

ADDITIONAL VIEWS OF SENATOR TOMOTHY E. WIRTH

THE FINANCIAL MODERNIZATION ACT OF 1988

The Financial Modernization Act of 1988 is a product of compromise among the 20 Members of the Senate Banking Committee. All of us on the Committee had different ideas about what we wanted to see in a bill. For example, I argued for a go-slow approach with respect to the repeal of Glass-Steagall. The current fragility in the financial marketplace, as well as the recent October 19, 1987 market crash, convinced me that if banks are to be allowed any further exposure whatsoever to the securities business, then a phased-in approach is the soundest policy. This view is shared by the General Accounting Office as well as many others. I also support tighter "firewalls" separating the securities affiliate of a bank holding company from the activities of the bank itself and believe that all securities activities of a bank should be placed eventually in a securities affiliate. That affiliate should be a pure securities affiliate and I do not believe that other nonbanking activities that are permissible for bank holding companies should be conducted in it (e.g. leasing, mortgage banking, management consulting, financial counseling, and dealing in precious metals.)

In spite of these reservations, there was a willingness to compromise with respect to the timetable of the actual phase-in in order to ensure passage of legislation. This compromise is justified in order to avoid the dangers of allowing the Federal Reserve Board and the independent bank regulatory agencies to establish public policy on a piece-meal basis regarding bank entry into the securities area. Major public policy decisions in the financial services area should be made by the Congress, not the regulatory agencies. Comprehensive legislation is necessary to provide the essential structure and safeguards controlling bank and bank holding company securities activities as well as other products and services in the future.

The Financial Modernization Act is an outgrowth of the moratorium we established on new bank powers in last year's Competitive Equality Banking Act. As promised, the Committee used the moratorium as an opportunity to carefully consider the issues in any restructuring of the financial services industry. The moratorium also served as an incentive for the various financial services industry groups to put forward recommendations regarding industry restructuring. Their recommendations and others were carefully weighed by the Committee.

In this regard, it should be stressed that this bill represents a legislative initiative to rationalize financial services law in a significant fashion. As a result, I expect that the regulatory agencies will continue to defer action on any new powers at least until this legislation has been fully considered by the Congress.

Of particular interest and concern to me in the Committee's considerations on this bill was the treatment of the Glass-Steagall issue. The bill significantly repeals the 50 year old Glass-Steagall Act by permitting banks to directly underwrite some types of securities and to affiliate with securities firms engaged in other underwriting activities. Bank holding companies are permitted immediately to underwrite revenue bonds and mortgage-backed securities as well as other asset-backed securities. Additionally, bank holding companies will be authorized to underwrite mutual funds and corporate debt in 6 months following enactment. Corporate equity underwriting may be permitted in 1991 if Congress votes to authorize it at that time pursuant to expedited procedures which mandate a vote on the issue. This approach with respect to equity underwriting will give Congress an opportunity to observe the overall effect of granting the other new securities powers prior to granting the higher risk equity underwriting authority.

The securities industry is a highly risky business as recent market events clearly demonstrated. Only 6 months ago, on October 19, 1987, about \$500 billion in value was wiped out when the Dow Jones Average plummeted almost 23 percent. Enormous losses and layoffs are the order of the day in the securities industry. A number of people believe that the stability of the banking system in the face of this market crash is a tribute to the vision of the authors of Glass-Steagall. It is clear that the risk concerns underlying the separation of commercial and investment banking have not necessarily disapproved over the years.

A measured approach to any repeal of Glass-Steagall is consistent with recent findings by the General Accounting Office. Only last month, the GAO advised Congress that "It is worth recalling the motivation that prompted the passage of the Glass-Steagall Act in 1933: a determination that depositors would never again face the risks that stemmed from the near collapse of the U.S. commercial banking system as the Great Depression deepened in the early 1930's. The original intent of the Glass-Steagall laws remains just as valid today as it did then." The GAO concluded that very serious deficiencies in the existing regulatory structures require a phased approach to any consideration of repeal of Glass-Steagall. They recommend, "this would involve bank holding companies undertaking only a subset securities activities or limiting securities activities to a certain percentage of the holding company's total business. In time, as more experience is gained and regulatory resources are put in place, the limits on activities could be relaxed and, if no problems occur, fully phased out." The approach adopted by the Committee in the Financial Modernization Act is generally in keeping with the GAO's recommendations, although it is doubtful that the GAO would have gone quite as far as would a majority of the Committee.

I want to particularly highlight the GAO's concern with the adequacy of the existing regulatory structure. Over the past 2 years, the Securities Subcommittee has carefully reviewed the budget authorization of the Securities and Exchange Commission and has concluded that the ability of the Commission to respond to even its current regulatory demands is in question. In the period of 1980-1987, during a time of unparalleled growth in the volume and com-

plexity of the securities markets, the SEC was actually required to cut its staff by over 100 staff years. Chief executives of major securities firms appeared before the Subcommittee and urged Congress to increase the SEC's budget by as much as 100 percent. Congress eventually approved an increased authorization of about 30 percent without a single dissenting vote in either house. Further, the new Chairman of the SEC made a special request to the Committee in late 1987 to intercede in the budget process on behalf of the Commission to avoid any reduction in the SEC's appropriation. As a result, 19 of the 20 Members of the Banking Committee signed a letter to the Appropriations conferees urging that the SEC's budget be left intact. It is painfully apparent that the Commission has not been permitted to keep regulatory pace with its existing responsibilities—without even considering the burden of new oversight authority for bank securities affiliates.

In this regulatory environment, it would be irresponsible for Congress to take a step as far reaching as an immediate, unconditional repeal of Glass-Steagall as originally proposed by Senators Proxmire and Garn. As the GAO has noted, it should be established first that the SEC and the other regulatory agencies can fully handle the additional regulatory responsibility for the securities activities of bank affiliates stemming from this change in the law. Any decision to roll back Glass-Steagall restrictions must be premised on confidence that the potential abuses and risks to the financial system can be controlled through regulation. I remain unconvinced that the SEC can carry this burden today due to the resource restrictions placed on the agency over the past several years.

There are other good reasons supporting a cautious approach to new securities activities for bank holding companies. Our financial services industry is currently experiencing some considerable stress. Money center banks have billions of dollars in questionable loans to less-developed countries. Energy, agriculture, and real estate loans are burdening banks throughout the Southwest and Midwest. Bank failures are expected to continue at a record breaking pace and the plight of the Federal Savings and Loan Insurance Corporation is well known. It may be true that the power to diversify into the securities business could provide at least a partial solution to some of these problems. But we have also seen that new powers did not solve the crisis in the thrift industry. In fact, many have argued that new powers led to new losses for desperate thrift institutions and that the taxpayers may still end up with the bill for a savings and loan system bailout totalling billions of dollars.

All of these factors mandate considerable caution on the part of Congress in authorizing new high risk underwriting powers to banks. The Financial Modernization Act provides for first granting the less risky securities powers with a reservation of equity underwriting until 1991. At that time some record of the effects of the other new powers can be weighed. This interim period will also allow necessary time to assure that adequate regulatory resources are available.

Under the bill's treatment of Glass-Steagall, a number of safeguards will be put into place on transactions between a bank and

its new securities affiliate. These measures are designed to protect the safety and soundness of the bank and to avoid any unfair competitive advantage flowing from the federal guarantee backing the bank. The extent of this safeguarding insulation, or "firewalls," which may be necessary in order to avoid the practices which led to the enactment of Glass-Steagall in the first place has been the subject of considerable debate. Some, such as former Federal Reserve Board Chairman Paul Volcker, have expressed reservations that a bank can ever be truly shielded from its securities affiliates. However, the Committee has determined that the safeguards contained in the Financial Modernization Act are adequate to avoid the potential problems without unduly or unfairly restraining the business relationships within a bank holding company. While I generally agree that the bill provides at least the minimum level of necessary safeguarding limitations, there are some issues in this regard which are still troubling.

Specifically, the bill will allow a bank to engage in newly authorized underwriting activities directly within the bank rather than through a separate securities affiliate. Similarly, a bank holding company will be permitted to engage in certain types of underwriting in affiliates which are not "securities affiliates" under the bill. In both instances, these underwriting activities will not be subjected to the safety and soundness safeguards in the bill limiting transactions between a bank and its securities affiliate. For example, a bank will be newly authorized by the bill to underwrite municipal revenue bonds. Further, these bonds may be underwritten in the bank itself rather than the securities affiliate and the bank may permissibly guarantee these bonds with a letter of credit. But if a securities affiliate underwrote the same revenue bonds, the bill would prohibit the bank from backing the issue in this manner. This is presumably justified as a means to eliminate the danger of compromising the bank's credit judgment in backing underwriting activities which will benefit the securities affiliate. It also minimizes the danger that the bank will be able to exploit its Federal guarantee as an unfair competitive advantage in marketing underwriting services.

I fully support these safeguards but I am concerned that if they are justified between a bank and its securities affiliates they are equally justified for the newly authorize underwriting activities conducted in the bank itself (or through other bank affiliates engaged in underwriting but not subject to the safeguards applicable to securities affiliates). In fact, under the bill as it stands, a bank is actually encourage to move underwriting activities into the bank, increasing the risk to the bank and the potential for abuse, in order to avoid the bill's safeguards on transactions between a bank and its securities affiliate. This result is inconsistent with the bill's otherwise evident concern over the historically proven dangers of direct bank involvement in underwriting activities. The bill's own logic should mandate that all newly authorized underwriting activities must either be conducted in a securities affiliate or subjected to the same safeguard provisions as if they were underwritten in such an affiliate. I am hopeful that this issue can still be resolved. Otherwise, I believe that there is a glaring and irresponsible inconsistency in the treatment of securities activities conducted within the bank itself versus in a separate securities affiliate.

I have other reservations about the legislation. But, on balance, I believe that the positive aspects of passing the Financial Modernization Act outweigh the many arguments against it and the dangers stemming from the alternative of doing nothing legislatively.

Finally, I want to pay particular tribute to our Banking Committee Chairman, Senator William Proxmire. Once again, as so often throughout his career, he has forged ahead and notwithstanding some considerable pressure, produced an historic piece of legislation. He and former Chairman and current ranking minority member Jake Garn are to be applauded for their leadership on this issue as well as on so many others throughout the years. Senator William Proxmire has been an outstanding Chairman of the Senate Banking Committee and we will miss him greatly after the end of this session when he retires.

TIMOTHY E. WIRTH.

ADDITIONAL VIEWS OF SENATORS GARN AND BOND

We must respectfully disagree with the statement in the Report that conducting bank securities activities through affiliates of a holding company "is a much sounder alternative than allowing subsidiaries of the bank to engage in a full range of new securities activities." We believe it is important that such securities activities be carried out in separate entities. But the bank subsidiary structure is just as sound as the affiliate structure, provided the same protections that insulate a bank from its holding company affiliates also made to apply to insulate the bank from its direct subsidiaries. We agreed to support the affiliate approach only as part of an overall compromise to ensure that this important legislation is enacted.

Our views on the subsidiary approach are shared by the Federal Deposit Insurance Corporation. It believes, based on its professional supervisory experience, that banks can be insulated from the activities of their subsidiaries as effectively as they can be insulated from those of their holding company affiliates. As the FDIC stated in its testimony before this Committee:

"If banks are adequately insulated—and we believe the insulations contained in S. 1886 are more than adequate—then from a safety and soundness viewpoint it is irrelevant whether nonbanking activities are conducted through affiliates or subsidiaries of banks."

Moreover, there are approximately 4,500 banks that do not now have holding companies. These banks, most of which are small, will have to bear greater costs in forming a holding company, (although the bill does take important steps to reduce these costs). Under a subsidiary approach, small banks could form a joint-venture to conduct activities securities and, thus, have the additional benefits that arise from economies of scale. The Comptroller of the Currency made the point when it testified as follows:

"Our principal objective in reforming the Glass-Steagall Act is to increase competition in the financial services marketplace. We will succeed in achieving that objective only to the extent that we offer new-powers opportunities to the largest possible number of commercial banks. The lower we can keep the cost of entering new markets, the larger will be the number of new entrants. A bank-subsidary approach keeps the cost of market entry low."

There are other distinct advantages in undertaking these activities in a bank subsidiary. Earnings of the subsidiary flow to the bank and, if necessary, the subsidiary can be sold to raise capital for the bank. In addition, if, as is recommended by the agencies, the capital invested in the subsidiary is over and above the regulatorily required capital for the bank, the bank's capital would not be jeopardized if the subsidiary gets into trouble.

We continue to support the bill strongly, but I wanted to set the record straight on the equally sound approach of using bank subsidiaries.

JAKE GARN.
KIT BOND.

